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PRINCIPLES AND PRACTICE OF AUDITING

(A Practical Manual for Indian Students and Practitioners)

SUPPLEMENTED BY

150 SPECIMEN QUESTIONS AND ANSWERS

BY

JAMSHED R. BATLIBOI, F.S.A.A. (HONS.), R.A.

(of the firm of Batliboi and Purohit)

Fellow and Honoursman of the Society of Incorporated Accountants and Auditors; Founder and former Principal, Batliboi's Accountancy Training Institute, Bombay; Author of "Advanced Accounting", "Typical Problems in Advanced Accounting", "Double-Entry Book-keeping", "Questions & Answers in Book-keeping and Accounting", "Works Organisation, Management & Cost Control" and "The Problem of Labour Discipline in our Industries".

SEVENTH EDITION

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PREFACE TO THE SEVENTH EDITION.

The ever-increasing demand for this work has necessitated a New Edition. No changes have been made in the arrangement and the subject-matter of the text as appearing in the last edition, as these have met with general approval by the teachers and students alike.

In order to add to the usefulness of the work, however, any constructive suggestions from my readers would be most thankfully received. I shall also feel obliged if my attention is drawn to any discrepancies that might have inadvertently crept in.

My best thanks are due to Mr. Shiamuk J. Batliboi for his very valuable help in reading the proofs.

JAMSHED R. BATLIBOI.

9th July 1948.
National Insurance Building,
Hornby Road, Fort,
Bombay.

PREFACE TO THE FIRST EDITION.

As a lecturer on Auditing to large classes of Indian students for the last twenty-three years, I had always felt the need for a work on this subject written specially for them. The object of the present work is thus to provide Indian students with a manual outlining the general principles of Auditing and setting out the routine followed in professional practice, in a summarised form, so that a study of the same may help them in attaining the high standard of knowledge required for the examinations of the Government Accountancy Diploma Board, of the Indian Universities (for their Commerce Degrees) and of other Examining Bodies. While compressing the entire subject within 216 pages, great care has been taken to see that the book embodies information on every point likely to arise in examinations.

The subject of Company Audits under the Indian Companies Act has received special attention and has been dealt with at considerable length, and I have no doubt this will prove invaluable to Indian Students and Professional Auditors.

With a view to help the students in testing their knowledge while preparing for examinations, papers set at the examinations of the Government Accountancy Diploma Board from 1921 to 1929 have been given at the end of the work.

Although this work is intended primarily for students, it is hoped that, on a careful perusal, professional auditors will find in it many useful hints and practical suggestions.

As this is the first work of its kind ever attempted by an Indian, I shall welcome suggestions from readers with a view to enhance its usefulness, and shall deem it a favour to be informed of any inaccuracies that may have inadvertently crept in.

JAMSHED R. BATLIBOI.

Bombay, 7th November, 1929.

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PRINCIPLES AND PRACTICE OF AUDITING

CHAPTER I

AUDITS AND AUDITORS

DEFINITION

Auditing may be defined as an intelligent and a critical scrutiny of the books of account of a business with the documents and vouchers from which they are written up, for the purpose of ascertaining whether the working results for a particular period, as shown by the Profit and Loss Account, as also the exact financial condition of that business, as reflected in the Balance Sheet, are truly determined and presented by those responsible for their compilation.

An audit thus involves not only an examination of the book entries to ascertain that they are duly incorporated into the final accounts, but it also entails an exhaustive verification of the supporting vouchers and documents to ensure that the book entries themselves have been correctly made so as to form a true record of the business transactions. It further seeks to determine that the transactions are properly authorised and are in the usual course of the particular undertaking and that the results of the transactions in the aggregate, for the period under audit, are accurately shown in the statements of account which the auditor is called upon to certify.

OBJECTS OF AN AUDIT

The main objects of an audit are:—

- (1) To detect clerical errors and errors of principle;
- (2) To detect fraud, if any exists; and
- (3) To prevent fraud and errors.

It will be seen from the above that the chief function of an audit is to detect fraud and errors. Errors may be divided into clerical errors and errors of principle. Clerical errors may either consist of errors of commission or errors of omission. Errors of commission include incorrect entries in the original records, wrong postings, castings, calculations, extensions and carry forwards. Ordinarily, the presence of such errors would be revealed by the non-agreement of the Trial Balance and would be detected by the auditor in course of his routine checking. Errors in calculations, however, will not be disclosed by the audit inasmuch as the agreement of the Trial Balance will not be affected thereby. For instance, if mistakes are made in the working out of prices in Outward Invoices, the wrong amounts would naturally be entered in the Sales Book. These wrong amounts would be debited to the customers' accounts in the Ledger, and would also be included in the periodical total of the Sales Book and posted to the credit of the Sales

Account. Similarly, errors of omission which consist of transactions being omitted to be entered in the original records will not affect the agreement of the books. Whether such errors of omission will materially affect the results shown by the accounts or not would depend on the nature of such omissions. It should be noted, however, that errors of omission are sometimes committed intentionally with a view to falsify the accounts, and, under such a circumstance, they would affect the resulting profits vitally. Although such omissions are rather difficult for the auditor to trace, yet by a thorough and efficient performance of his duties, he is ordinarily supposed to be able to discover these.

Errors of principle, as a rule, affect the accounts considerably, and the detection of such errors is, of course, always involved in all auditing work. Errors of principle may arise from the valuation of assets on a fundamentally wrong basis, or from ignoring questions of outstanding liabilities or assets, or from an inadequate provision in respect of doubtful debts or depreciation, or an incorrect apportionment of expenditure between Capital and Revenue. As such errors are usually committed purposely with a fraudulent intention of presenting a false statement, and as they affect the Profit and Loss Account and Balance Sheet most vitally, it is very necessary for the auditor to be always on the look out for such errors. He must understand, however, that such errors will never be discovered by mere routine checking in a mechanical way, but only by carrying on the investigation in a thorough, intelligent and searching manner.

The detection of errors is the primary duty of an auditor, as his clients would naturally expect him to place before them accurate statements of accounts indicating a true and correct financial view of their business. It should not be lost sight of, however, that the detection of fraud is of equal importance in determining the operating results and the financial condition of the business. The possibility of fraud should, therefore, be uppermost in the mind of an auditor, but not to such an extent that he should always adopt an attitude of suspicion. Far from going about with an air of suspicion, superiority or conceit, he must be extremely polite in his ways and must acquire an attitude of quiet dignity. He should always be slow to criticise, and must carefully weigh the assertions and opinions of those in management before coming to any decision. If, however, in course of his work, he comes across any transaction which arouses his suspicions, it becomes his duty to thoroughly investigate the matter without any fear or favour to enable him to arrive at a proper conclusion. If, as a result of his examination, he detects any false state of affairs, it would be incumbent upon him to make a report to that effect to those on whose behalf he has been called upon to audit.

Fraud may take place either by actual misappropriation of cash or goods, or by falsifying accounts without any misappropriation. The misappropriation of cash may take the shape of either omitting to enter a receipt, or

acknowledging a less amount than has been actually received, or entering an absolutely fictitious payment or showing a payment of a much larger amount than what has been actually made. But such misappropriations are not difficult of detection by a careful comparison of the entries in the subsidiary books with the original vouchers relating thereto. Misappropriation of goods, on the other hand, is rather difficult to detect unless stock records are maintained showing the quantities of goods that have come in and the quantities that have been issued out from time to time.

There are instances, however, where the accounts are falsified by managers and directors showing highly inflated profits purposely with a view to serve their own ends, either for securing a larger amount of commission due to themselves, or for disposing off their holdings in the concern at high profits, or to be able to pay a dividend which would not otherwise be payable, or for borrowing money or securing more capital for their concern. Such frauds are usually perpetrated by persons enjoying higher and responsible position on whose information and explanations the auditor has usually to rely. It will thus be seen what a considerable amount of care, skill and vigilance are required of an auditor in order to make his work effective and useful.

ADVANTAGES OF AN AUDIT

The following may be stated as amongst the chief advantages accruing from an audit:—

(1) Apart from detecting fraud and errors, a regular audit would tend to keep the books of accounts up-to-date, and would exercise a great moral influence on the staff so as to prevent fraud and errors.

(2) The proprietors of the business would have placed before them, at periodical intervals, reliable statements of accounts indicating the true causes of fluctuations in expenses or in earnings and the true financial position of the concern, after independent verification by an expert.

(3) Audited accounts would certainly be more relied upon for the following purposes:—

(a) For obtaining additional capital or borrowing moneys.

(b) For Income-tax Assessment.

(c) For securing compensation claims in respect of loss by fire or in case of compulsory removal of business.

(d) In case of a proposed sale of the business or its conversion into a joint-stock enterprise.

(4) In a partnership firm, audited accounts, when signed by the partners, would tend to prevent any dispute between them in matters of accounts.

ACCOUNTING AND AUDITING

The exact distinction between Accounting and Auditing needs to be clearly understood. Accounting is concerned with the recording of current business transactions in a manner as would facilitate the ascertainment of the resultant profit or loss and the correct assets and liabilities by the preparation of Profit and Loss Account and Balance Sheet at convenient intervals. Auditing is the subjecting of such records to a critical examination, by an independent expert, for the purpose of testing their accuracy, and to see that the final statements as prepared therefrom do convey a true and correct view of the financial state of affairs, to the interested parties.

A professional accountant is sometimes called upon to prepare accounts from a set of books. This would naturally involve the agreement of the Trial Balance, the making of the necessary adjustments, and thereafter, the preparation of the Profit and Loss Account and the Balance Sheet. Under such a circumstance, he would be acting simply as an accountant, and not as an auditor. He would not conduct, in this case, a proper audit of the whole of the transactions of the business, but would only see that the Balance Sheet is drawn up in accordance with the books. He would, therefore, be careful not to certify the Balance Sheet prepared by him as being correct, but would state just above his signature, in clear terms, the fact that such Balance Sheet has been prepared by him from books of account without verification.

On the other hand, when a professional accountant is called upon to audit a given set of accounts, the Balance Sheet would be prepared by others, and the auditor would have to make a searching examination of such Balance Sheet with the books, accounts and vouchers relating thereto so as to be able to honestly report to his clients that it is properly drawn up and exhibits a true and correct financial state of the business, as shown by the books, and according to the information and explanations given to him. In short, the duty of an auditor is to make an independent investigation and report upon accounts prepared by others. Ordinarily, the report of the auditor is placed at the foot of the Balance Sheet, and it then serves to indicate that the audit has been duly completed and that the auditor has fully discharged his duties.

RECORD OF ENGAGEMENT

After having arranged with a client for an audit, it is desirable for the auditor to see that the terms of such engagement are put in writing. Such a record may be embodied in a letter to the client duly confirmed by him, and must contain special instructions, if any, given by the client. There should be a definite understanding as to what work is to be done, when it is to be taken up, within what period it is to be completed and the fee to be charged. If the auditor is required to conduct a partial audit covering only a particular set of transactions, it is still more desirable for him to have a very clear understanding with the client regarding the scope of the work and the responsibility

undertaken. These terms of engagement would also be entered in the audit memoranda for his future reference and the guidance of the staff. Such a record would prove very valuable in case of any dispute arising out of a misunderstanding as to the ground the auditor's investigation should cover.

HOW TO BEGIN A NEW AUDIT

To begin with, an auditor should never rush heedlessly into the details, but should first make a careful survey of all the conditions that are likely to have any bearing on the work he is called upon to perform. He must ascertain the exact nature and scope of his duties by reference to the instructions received from his clients or to statute. He should then familiarise himself with the peculiar nature of the business and its technical details. If there are any technical features of the business which call for elucidation, he should obtain information on these without hesitation, as no audit can be thorough unless the auditor has grasped the peculiar nature of the business.

The system of book-keeping and the internal check obtaining in that business should next be thoroughly studied by him. This he should do with a view to determine the ground to be covered by his investigations, and to decide for himself to what extent he can safely rely on the internal check already existing. If he finds any weak spots in the system of account-keeping or of the internal check in existence, he should, of course, devote special attention to these, and should seek to remedy the existing defects by recommendations.

He should next obtain a list of all the books of account used in the concern, and ascertain the respective duties of the members of the staff. It would be equally necessary for him to make a careful study of the documents which would form the very foundation of his work, such as the Partnership Deed in the case of a Partnership Audit, the Memorandum and Articles of Association in the case of a Company Audit, the Will or the Trust Deed in the case of a Trust Audit. Where there is any system of internal check in existence, the auditor would do well to obtain a written statement as to the extent and scope of such system. He would now be able to adopt a definite plan of procedure, which he must carry out thoroughly and conscientiously, if the audit is to be really efficient.

Not infrequently, he would find that the additions of Ledger Accounts and the balances brought down are in pencil; or it may be that the accounts are not ruled off and the balances are not brought down. Under such a circumstance, the auditor should insist that all additions are inked, and that all accounts are properly ruled off, and the balances, if any, are brought down in ink before he commences with his work.

AUDIT PROGRAMME

Before commencing with the detail work, a complete programme of general work to be performed by the principal and his staff must be outlined.

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The exact distinction between Accounting and Auditing needs to be clearly understood. Accounting is concerned with the recording of current business transactions in a manner as would facilitate the ascertainment of the resultant profit or loss and the correct assets and liabilities by the preparation of Profit and Loss Account and Balance Sheet at convenient intervals. Auditing is the subjecting of such records to a critical examination, by an independent expert, for the purpose of testing their accuracy, and to see that the final statements as prepared therefrom do convey a true and correct view of the financial state of affairs, to the interested parties.

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On the other hand, when a professional accountant is called upon to audit a given set of accounts, the Balance Sheet would be prepared by others, and the auditor would have to make a searching examination of such Balance Sheet with the books, accounts and vouchers relating thereto so as to be able to honestly report to his clients that it is properly drawn up and exhibits a true and correct financial state of the business, as shown by the books, and according to the information and explanations given to him. In short, the duty of an auditor is to make an independent investigation and report upon accounts prepared by others. Ordinarily, the report of the auditor is placed at the foot of the Balance Sheet, and it then serves to indicate that the audit has been duly completed and that the auditor has fully discharged his duties.

RECORD OF ENGAGEMENT

After having arranged with a client for an audit, it is desirable for the auditor to see that the terms of such engagement are put in writing. Such a record may be embodied in a letter to the client duly confirmed by him, and must contain special instructions, if any, given by the client. There should be a definite understanding as to what work is to be done, when it is to be taken up, within what period it is to be completed and the fee to be charged. If the auditor is required to conduct a partial audit covering only a particular set of transactions, it is still more desirable for him to have a very clear understanding with the client regarding the scope of the work and the responsibility

undertaken. These terms of engagement would also be entered in the audit memoranda for his future reference and the guidance of the staff. Such a record would prove very valuable in case of any dispute arising out of a misunderstanding as to the ground the auditor's investigation should cover.

HOW TO BEGIN A NEW AUDIT

To begin with, an auditor should never rush heedlessly into the details, but should first make a careful survey of all the conditions that are likely to have any bearing on the work he is called upon to perform. He must ascertain the exact nature and scope of his duties by reference to the instructions received from his clients or to statute. He should then familiarise himself with the peculiar nature of the business and its technical details. If there are any technical features of the business which call for elucidation, he should obtain information on these without hesitation, as no audit can be thorough unless the auditor has grasped the peculiar nature of the business.

The system of book-keeping and the internal check obtaining in that business should next be thoroughly studied by him. This he should do with a view to determine the ground to be covered by his investigations, and to decide for himself to what extent he can safely rely on the internal check already existing. If he finds any weak spots in the system of account-keeping or of the internal check in existence, he should, of course, devote special attention to these, and should seek to remedy the existing defects by recommendations.

He should next obtain a list of all the books of account used in the concern, and ascertain the respective duties of the members of the staff. It would be equally necessary for him to make a careful study of the documents which would form the very foundation of his work, such as the Partnership Deed in the case of a Partnership Audit, the Memorandum and Articles of Association in the case of a Company Audit, the Will or the Trust Deed in the case of a Trust Audit. Where there is any system of internal check in existence, the auditor would do well to obtain a written statement as to the extent and scope of such system. He would now be able to adopt a definite plan of procedure, which he must carry out thoroughly and conscientiously, if the audit is to be really efficient.

Not infrequently, he would find that the additions of Ledger Accounts and the balances brought down are in pencil; or it may be that the accounts are not ruled off and the balances are not brought down. Under such a circumstance, the auditor should insist that all additions are inked, and that all accounts are properly ruled off, and the balances, if any, are brought down in ink before he commences with his work.

AUDIT PROGRAMME

Before commencing with the detail work, a complete programme of general work to be performed by the principal and his staff must be outlined.

A separate book should be maintained for the audit of each concern, and columns should be provided therein for showing the names or initials of the clerks performing the work. Full particulars should be recorded as to the periods selected for tests, the dates when the work was done and the time it took to perform. This information comes in very useful for the purpose of supervising the work of the auditing staff. Further, it enables the principal or his responsible clerk to ascertain at any time, what portion of the work has been done, by whom it has been done, and what remains to be done to complete the audit.

Some firms employ a standard form of audit programme to be used in all cases. Such a practice is, however, undesirable as it discourages initiative on the part of the auditing staff and makes them lose their sense of responsibility. Besides, no two audits, even in the same line of trade, would present the same problems to be solved, and consequently, in order that the audit may be done efficiently, it is highly necessary that the exact scheme of work should be mapped out, after carefully considering the particular requirements of each case.

With a view to prevent the audit work becoming mechanical, the clerks should also be encouraged to suggest improvements in the plan of work from time to time as they may deem desirable, and the same scheme of work should not be followed for two successive periods. The programme should be varied by the principals after a fresh study of requirements from time to time.

AUDIT NOTES AND WORKING PAPERS

It is necessary to possess some handy record of the work performed in connection with every audit as also of the several queries that arise during the course of such audit. A separate book styled "Audit Memoranda" is thus maintained for each audit in which is set out a programme of work to be performed, as already explained above. A complete record should be kept in this book of all the various questions raised in the course of the audit, and the explanations, information and instructions received from those in management.

Careful notes should also be made of all errors discovered and adjusted, of all important things that call for discussion with the client, of all vouchers, invoices, etc., missing, and of such other matters as may prove material for the report. Care should be taken not to overload the notes by entering therein insignificant errors and queries. These should be settled and adjusted as they arise.

Too much stress cannot be laid on the desirability of most carefully preserving and filing the working papers in connection with each audit including the draft accounts and the several schedules relating thereto. The audit notes as also the working papers prove considerably helpful, if anything goes wrong and the auditor is called upon to explain and defend his position on some future occasion. It may be that the trouble arises some years after

the work was performed, and if the auditor has no such record indicating what work he performed, what queries he raised and how and by whom they were explained, he would surely find himself in a most unenviable position.

CHECK MARKS OR "TICKS"

Each office has its own method of ticking the entries for the purpose of knowing what checking has been done. Such ticks, however, should be very neat and small and should not be made in a manner as to be mixed up with the figures against which they are made.

There should be special and distinctive ticks for vouching, checking of postings, verification of castings and carry forwards.

The client's clerks should not know the exact significance of the various types of ticks, and they should never be allowed to make similar ticks in the books.

Where a figure is badly written or there is any alteration, a good rule would be for the auditor to write the correct figure near the altered or illegible figure. A special tick may also be adopted and made against every altered or indistinct figure, so that by a mere look at that tick on a subsequent occasion the auditor may be able to tell whether the alteration was there at the time the item was checked or not.

It is desirable to adopt ink or pencil of a different colour to that usually used in the client's office. It is further advisable to use a different coloured pencil or ink for each trading period, so that entries of the current period may not be confused with those of the previous period.

INTERNAL CHECK AND THE AUDITOR

Having undertaken an audit, as to how far the auditor should check the details and whether he should verify all the entries or limit the checking to certain tests will depend largely upon the system of internal check in use in the concern. Where the business is a small one, the book-keeper has generally full control over all the books of accounts and anything like an internal check is lacking, it will be necessary for the auditor to verify the whole of the transactions with the original records, call over the whole of the postings, check all the casts, and agree the books. Even in case of an extensive business, where the books have not been properly maintained and not agreed, and there is lack of efficient control, the auditor must necessarily check a substantial portion of the transactions. In a large business, however, where the auditor finds a sound system of internal check in use, he need not necessarily examine all the entries. He can in that case do away with a considerable amount of detailed checking by curtailing ticking and casting, and restrict the routine work to certain periods he may select by way of tests. If in the course of these tests no irregularities are disclosed, he may safely take it that the rest of the work is equally correct. On the other hand, if such tests indicate the existence of several errors or lead to the slightest suspicion

of fraud, he must necessarily extend the scope of his investigation, and, if need be, must check every entry.

The main point to be borne in mind is that the auditor must not be satisfied by merely checking the entries with the books of account, but he must go, to a certain extent, behind the books. Ticking does not prove that all cash received has been duly accounted for, or all payments as entered up are properly made, or that all sales have been shown in the Sales Book, or that all goods as shown in the Purchase Book have been duly received. He must, therefore, take the greatest care and precaution to ascertain that the books in themselves embody a correct and complete record of all the transactions of the period under audit. It would be absurd on his part to expect to detect fraud or errors of principle by mere routine checking. For the audit to be effective, the whole of the work must be done on sound and intelligent lines.

In deciding upon the portion of entries to be examined as tests, due regard should be had to the system of internal check, and the auditor should find out in what directions there is any likelihood of an irregularity or a serious discrepancy existing. For instance, if on enquiry he finds that the handling and recording of cash receipts and payments is subjected to a sound internal control, but the incomings and outgoings of goods have not been properly attended to, he should most minutely scrutinise the original vouchers and records relating to purchases and sales, and restrict the checking of the record of cash receipts and disbursements to a low percentage of tests. Further, the auditor should be careful not merely to rely on the rules as laid down for internal organisation and control, but must satisfy himself by due enquiry that these rules are rigidly enforced.

In case of a new audit, it is very necessary for the auditor to ascertain from his client the purpose of the audit. If the purpose is for the auditor to find out that there are no errors or irregularities, a complete audit is necessarily required. If it is desired by the client that only a particular series of accounts or transactions be checked, or that some particular feature of the business be investigated into and reported upon, the auditor need examine only the portion he is asked to cover. In that case, he should be careful to qualify his certificate accordingly, stating in explicit terms the fact of a partial verification having been performed, and clearly expressing the degree of responsibility assumed.

DIVISION OF WORK BETWEEN SENIOR AND JUNIOR CLERKS

For the efficient conduct of audits, it is usual to divide the work of each audit between the junior and the senior audit clerks. The distinction between seniors and juniors for this purpose would be in relation to their experience and ability rather than age.

A certain number of audits would be assigned by the principal to each senior, and each senior in his turn would be assisted by a certain number of

juniors. The junior will work under instructions from his senior and will be directly responsible to him for his work. It will be his duty to carry out such directions faithfully and diligently.

To the junior will be allotted work requiring less skill and technical knowledge, such as checking of the original records with their supporting vouchers and documents, postings of the subsidiary books in the Ledger, casts and cross casts of the subsidiary books and the Ledger accounts, and the checking of the Ledger balances into the Trial Balance. In more responsible audits, the verification of the Journal as also the vouching of the Cash Book, and sometimes even the vouching of the Invoice Book are left to be attended to by the senior.

It will be the junior's duty to verify the extensions of some of the items of stock inventories and the additions of the stock sheets as also of the wages sheets. He will also be required to verify items of pre-payments, outstanding liabilities and accrued income.

For the smooth and efficient conduct of an audit, it is highly desirable that the junior should work in a spirit of whole-hearted co-operation with his senior, and keep him well informed of all matters which would call for further investigation or discussion with the client. He should most scrupulously avoid entering into any discussion on questions of accounting principles or the method of account-keeping obtaining in the concern or on matters appertaining to the internal check in force either with the client or with his office staff.

Even while performing such routine work of verifying the vouchers, calling over of amounts from the subsidiary books into the Ledgers, checking of the casts and cross casts, the junior should take extreme care to guard against methods which so easily become mechanical, and which are fatal to accurate and efficient auditing. It is here that the junior finds the training ground where he is disciplined in those qualities of accuracy and concentration which are so essential in the conduct of an auditor's profession. He should, therefore, acquire the habit of doing his work in a methodical and well thought-out plan, and not merely in a desultory manner.

In the process of vouching and routine work of the audit, no attempt should be made to pass over any entries or transactions which are not clearly or satisfactorily understood, but notes should be made of these to enable the senior to secure further information and explanation thereon.

The senior would come in constant contact with the client or with those in management of the concern whose books are being audited. At the commencement of each audit, it will be for the senior to decide in consultation with his principal, what work should be done, to frame the programme of work, to outline the methods to be pursued in the conduct of the audit, and to assign to each junior his respective duties.

He will then supervise the work of the juniors under his charge, watch their progress, make his own notes and accumulate materials on such points as would require further explanation or information from those in management, as also of such matters as are likely to be subjects for treatment in the report.

It will be the duty of the senior to go through the final stage of the audit and carefully scrutinise the several adjustments made in the preparation of the final accounts, the method employed in the valuation of stock and other fixed and floating assets, the question of adequacy or otherwise of the reserves made and the accuracy of the amounts capitalised.

He must generally undertake the verification of cash balances, securities, negotiable instruments, partnership agreements, contracts, mortgage deeds and all such important documents.

The senior should inspect the minute book, draft the report, if any, and discuss all questions of accounting principles involved in the audit with his principal. It will be his duty to keep in constant touch with the principal and inform him of all important matters that might arise in course of the audit in his charge. He would then finally discuss and review the draft of the report with the principal in order to decide upon the form in which it is to be rendered to the client.

With a view to promote and maintain most harmonious relations amongst the staff members and to sustain their interest in work, the senior should always readily discuss with juniors any points obscure to them and on which they would like to seek elucidation. He should also always be open to receive suggestions from the juniors. This will not only encourage independent thinking, but will stimulate efficient work.

AUDITS OF SOLE TRADERS OR PRIVATE FIRMS AND OF JOINT-STOCK COMPANIES

The position of an auditor to a sole trader or a partnership firm is quite different from that of an auditor to a joint-stock company, and this distinction needs to be clearly understood.

In a Limited Company, the appointment of an Auditor is made under the Indian Companies Act which defines his powers and duties, and under which he has a right of access to all the books of account, vouchers and documents of the Company whose books he is auditing. He is there to see that the directors render to the shareholders a faithful account of their stewardship; to see that the shareholders are informed of the true position of the business which belongs to them. He must sufficiently recognise that he is acting as the agent of the shareholders to scrutinise the accounts prepared by the directors, who are merely the servants of the shareholders. He must, therefore, act always in the best interests of the shareholders, even if by so doing he brings himself into conflict with the directors. He has a

right to ask for information and explanations from those in management on the several matters that arise in the course of the audit, and it is his duty to ascertain that the Balance Sheet he certifies reflects the true financial position of the Company.

He should not unnecessarily adopt an aggressive attitude towards the directors, and even if there arises any difference of opinion between himself and the board, he should try by his powers of persuasion, skill and diplomacy, to make the directors see things from his view-point. If the directors, however, refuse to budge from the stand they have taken and modify the accounts as he wishes them to do, he should act fearlessly, being prompted in all cases by only a conscientious desire to his duty, and report to the shareholders explaining to them the true state of affairs. Above all, he should remember that the powers granted to him by statute cannot in any way be limited or taken away from him either by the directors or the shareholders, and if the directors call upon him to conduct a partial audit or withhold from his inspection any book, voucher or document, he should resolutely refuse to give a clean certificate on the Balance Sheet.

On the other hand, an auditor to a sole trader or a partnership firm is appointed not under any statute but merely as a result of an agreement between himself and the client. In such a case, the general nature of his duties not having been defined by law, the express agreement between the auditor and his client must form the basis for determining the scope and object of the audit, and the auditor cannot always insist upon a full audit being carried out. He simply receives certain instructions from the client, which he should strictly and faithfully carry out. Where he is asked to conduct a full audit, it becomes his duty to scrutinise the books of account most carefully and exhaustively with a view to satisfy himself that the final accounts which he certifies as correct do represent true and accurate working results as also the financial condition of the business.

Very often, a professional accountant is called upon to prepare final accounts from books written up and agreed by others, without conducting any audit. The auditor, under such a circumstance, would do well to remember that his signature at the foot of the Balance Sheet might be utilised by his client for the purpose of obtaining loans or for securing a partner or for effecting the sale of the business. Besides, if the accounts as prepared by the auditor are afterwards found to be incorrect, the client might seek to hold him responsible. If, therefore, he receives instructions to prepare accounts without any examination of the books, it is highly desirable for him to inform his client in writing that he accepts no responsibility as to the accuracy of the Balance Sheet prepared by him, as the figures embodied therein have been taken from the books without verification. Further, if he is asked to sign such a Balance Sheet, he should refuse to do so, unless he is allowed to write the words "Prepared from books without verification", above his signature.

There are also occasions when he is requested to conduct a partial examination of the books and then prepare accounts. When an auditor is thus called upon merely to carry out a partial audit and then certify the accounts, he should refuse to do so unless he is allowed to qualify his report clearly indicating the fact of a partial audit having been done by him.

Where a partial audit is agreed upon, it would be highly advisable for the auditor to have the arrangement between himself and the client set out in writing embodying the instructions received from the client and clearly indicating the nature of the work entrusted to him. This is very essential in view of the fact that where a limit is placed on the scope of the work the auditor has to perform, it necessarily follows that the auditor's responsibility in this connection is reduced accordingly, and in case if anything goes wrong, the client might seek to hold the auditor liable for work he was never asked to perform and he had never undertaken. If, therefore, on such a circumstance arising, the auditor cannot produce in writing the exact terms on which his professional services were secured, he will find himself in a position of considerable difficulty.

CONTINUOUS AND PERIODICAL AUDITS

A Continuous or Detailed Audit involves a detailed examination of all the transactions by the auditor attending at regular intervals, say weekly, fortnightly or monthly, during the whole of the trading period.

A Periodical Audit or a Balance-Sheet Audit is one where the auditor attends only at the end of the financial period, and certifies the final statement of accounts after scrutinising the same with the books of account, vouchers and documents.

A Continuous or Detailed Audit has the following advantages:—

(1) As a result of the auditor attending at short intervals, mistakes are discovered earlier and soon rectified without any loss to the client.

(2) The frequent visits of the auditor have a great moral influence on the client's staff, and act as a deterrent to fraud and irregularity.

(3) The books of account would naturally be kept up to date, and a more detailed and exhaustive examination of the business transactions is possible than if the auditor were to put in an appearance at the end of the trading period.

(4) A detailed inspection of the books having been done during the trading period, the checking of the final accounts and the signing of the Balance Sheet will not be delayed much beyond the date of the financial close.

(5) By dint of constant attendance at the client's office, the auditor gets into closer touch with the technical details of the business and is thus able to render more valuable service to his client by way of suggestions for improvements in various directions than in the case of a Balance-Sheet Audit.

The only disadvantage arising from a Continuous Audit is that as the work is spread over the entire year, the book-keeper will have opportunities of altering the entries after their being checked by the auditor. To guard against this disadvantage, the following precautions may be taken by the auditor:—

(1) The client's staff should be strictly instructed not to erase or alter any figure already checked. If any alteration or rectification is found necessary, the same should be done by means of a Journal entry.

(2) The checking of each part of the audit should be done to completion.

(3) The periodical totals of the subsidiary books should be inked as and when they are checked.

(4) A slightly different tick from the ordinary should be used while checking figures which have been altered in any way before the audit. Such variation in the tick, must be very slight and unnoticeable and should not be known to the client's staff.

(5) All errors, queries and adjustments should be cleared as the audit proceeds, and not left to the last.

(6) Complete notes should be made of the work done from time to time, of the errors rectified, the queries raised and the explanations given.

QUALIFICATIONS OF A PROFESSIONAL AUDITOR

Many and varied are the qualifications required of a professional auditor. To begin with, he must be a thorough master of the science of accounting in all its phases, as he is often called upon to devise and instal methods of accounting as would save time and labour and yet meet all the requirements of any particular business. He must also be fully conversant with the principles and practice of business law and must have a thorough knowledge of the statutory duties, rights and responsibilities. He must acquire the habit of quickly grasping the technical details of any concern whose accounts he is called upon to audit.

A professional auditor must be prepared, whenever required, to introduce systems of cost accounts adapted to any manufacturing business whatsoever. He must be familiar with the best methods of recording time and payment of wages in large establishments, and must be able to institute regulations for internal check by way of precaution against fraud and irregularity, and to devise most efficient means of effectively controlling stock accounts and the receipt and issue of stores. He must possess an aptitude to grapple resourcefully with the constantly varying problems which often present themselves in the business world.

An auditor must be a man of affairs and must be able to apply his knowledge to any set of circumstances. He must not allow himself to be easily led or influenced by others, but must always make intelligent and

exhaustive enquiries to ascertain the exact state of affairs. He must never adopt an attitude of suspicion nor go about his work with an air of superiority or conceit. He must always be amenable to reason and argument and should never jump to conclusions without giving full consideration to the assertions and opinions of others. Far from adopting an attitude of open hostility to those around him, he should cultivate a spirit of mutual trust and goodwill between himself and the members of the client's office staff. Even his own staff members must be instructed to maintain always an attitude of extreme courtesy and good feelings towards the client's staff.

He should possess untiring application, utmost skill, constant care, firmness, patience and diplomacy. Occasions will undoubtedly arise when the performance of his duties would bring him in direct conflict with his own interest, but even in face of such difficulties he should carry out his duties most cheerfully and conscientiously in the best interests of his client.

If in course of the conduct of an audit, any questions arise which due to the peculiar technicality of the business are not clear to him from an inspection of vouchers or documents, he should not hesitate to seek elucidation on those by personal discussion with his clients. As a proper understanding of the true nature of the business is absolutely necessary in the satisfactory discharge of his duties, he should not allow any false pride or fear of displaying his own ignorance of affairs in preventing him from adopting such a course.

In course of his practice, some very delicate questions arise in his relations with his clients which call for the utmost integrity and moral courage on the part of the auditor. If it becomes necessary, an auditor should prefer to withdraw from an engagement rather than sign a statement of accounts, which he has reasons to believe is untrue and misleading.

The work of a professional auditor is always of a confidential character, and he should, therefore, take great care not to divulge his client's affairs to others. Last but not least, amongst the necessary qualifications of an auditor are sound common sense and courtesy.

CHAPTER II

VOUCHING AND ROUTINE CHECKING

GENERAL CONSIDERATIONS

A voucher may be defined as a documentary evidence in support of an entry appearing in books of account, and "vouching" means testing the truth of items appearing in books of original entry.

The object of vouching, generally speaking, is to satisfy the auditor on behalf of his client that the items in the books of accounts do in fact represent not only actual transactions, but, further, only such transactions which can be rightly deemed to be those relative to the affairs of the concern under audit. In course of vouching, the auditor should not allow his mind to lapse into mechanical methods, as this would rarely produce good results and discourage that alertness and rapid grasp of every detail which is so very essential to effective work. In addition to accountancy knowledge, it is essential that common sense, observation, and the critical faculty be brought into play. Experience has shown that methods of check, which are the most unexpected, prove the most effective, specially in the discovery of fraud. An incomplete and inadequate method of vouching will undoubtedly open up a number of opportunities to those in charge of the books to perpetrate fraud. As has been said before, in order to vouch accounts intelligently, the auditor must have a thorough working knowledge of those accounts, and a good grasp of the internal organization obtaining in that concern.

Great care must be taken in dealing generally with the vouchers. All vouchers appertaining to each particular original record should be numbered consecutively and properly filed in the order in which the corresponding items appear in the books. This will greatly facilitate reference both from the client's and the auditor's point of view. In the absence of a proper method of filing, much time is wasted in searching for vouchers, and as a result, vouching is rushed through of necessity at the expense of accuracy. The auditor should, therefore, always insist that before he commences his examination of vouchers, they should be filed in some definite order so as to permit of their full and easy inspection.

All vouchers relating to a particular book should be produced at one and the same time, and as far as possible, the inspection of vouchers covering some definite period should be completed at each sitting.

The most important points to be borne in mind while vouching are the date of each voucher, the name of the party from whom it is received, the party to whom it is addressed and the amount. It is equally important to see that the particulars mentioned on each voucher correspond with the record of the transaction in the books, e.g., if the voucher details the amount charged as for Repairs to Works Buildings it should be seen that it is entered as such and not wrongly capitalised.

Where the voucher is addressed to one of the partners or is in the name of the manager or one of the directors, enquiries should be made whether the items mentioned therein properly relate to the conduct of the business. If it is found on enquiry that the item in question was a personal debt of a partner, manager or director, the auditor should see that the personal account of such party is charged with the item. In case of any doubt, it is always advisable to refer, on the spot, to the Ledger Account to which the particular item is debited.

The verification of the dates is often overlooked, but it is very important to see that the dates on all the vouchers correspond with those under which the entries are made in the original records.

Care should also be taken to see that the amounts are correctly entered up and they are rightly posted to their respective accounts in the Ledger.

All vouchers must be properly cancelled as passed. This may be done either by means of a rubber stamp bearing the auditor's name or initials of the clerk doing the work, or by means of a special tick made right across the face of each voucher. The best method seems to be for the clerk in charge of the vouching placing his own initials on each voucher, as it fixes the responsibility on some definite person. In order that no voucher once passed may be presented again for audit, it is advisable to cancel all vouchers in the same way and place, and in order that the removal of the rubber stamp or initials or the tick may be rendered difficult, it is suggested that such mark should be made right on the middle of the voucher.

Whilst examining vouchers, careful notes should be made of the various items that call for further information or authority, or where additional evidence such as inspection of Minute Book, Articles of Association, Partnership Deed, Contracts or Leases is required for checking. Notes should also be made of any item of cash receipt or payment which would require apportionment or adjustment in the preparation of final accounts.

Sometimes, vouchers are missing, and in all such cases a list of these must be drawn up, and explanations as to the reason of their loss should be obtained from the person responsible. Duplicates of such vouchers must be obtained and all other available evidence should be seen to satisfy as to the correctness of such items.

The auditor should never allow himself to be persuaded to pass any transaction which is not properly supported by some voucher or other satisfactory evidence under the promise of future explanation, for fear of losing the client's goodwill or patronage.

It is highly desirable that under no circumstance should the staff of the client be allowed to help in the vouching, except for the purpose of tendering explanations which should always be accepted with care and caution.

Where the auditor finds that the volume of work involved in vouching every book entry would render the audit unnecessarily cumbersome and

lengthy, he may apply "test checks" with a view to curtail detailed vouching. But as to what extent he can do this safely, he should determine with due regard to the method of accounting and the system of internal control in use. While deciding upon this line of action, however, he should not lose sight of the risks involved, for the curtailment of work will not in any way lessen his responsibility.

There are occasions, however, where "short cuts" may be resorted to without incurring any risks. For instance, where there happen to be several properties and the Rent Rolls have been properly maintained, the auditor may satisfy himself as to the correctness of the total rents shown as received in the financial Ledger by reconciling the fact with the results as indicated by the Rent Rolls or the Tenants' Registers, in the following way. To the total Rents Receivable during the period under audit as ascertained from the Rent Rolls, the arrears of rent brought over from the previous year should be added. If the total of the rents remaining unpaid at the close of the current period, as arrived at from the Rent Rolls, is deducted from the above, the balance must represent the rents actually received during the period as shown by the Rent Account in the financial Ledger. This will of course be subject to any rents that may have been written off as bad and irrecoverable under proper authority. Where the Rent Rolls or Rent Registers are maintained on a sound and reliable basis, the auditor can thus save himself the unnecessary tedium of checking every entry in respect of rents. As a precautionary measure, however, he may supplement this work by a detailed checking of the Rent Bills, Rent Rolls, the Cash Book and the Rent Account for any odd period he likes, say two or three months, so as to satisfy himself as to the correctness of the records. He would, however, open himself to serious risks if he tries to apply such test checks in a business where there is lack of proper organization and control.

Where any item of payment is charged to an asset account, it would be particularly desirable for the auditor to make sure from an inspection of the original invoice that the amount has been rightly capitalised. Where there is any allocation between capital and revenue, it should be seen that such allocation is done on some reliable basis, and is duly authorised.

In handling the vouching in any audit, it is almost a general practice to commence with the Cash Book, which is acknowledged to be the fundamental book, in all systems of book-keeping. The Cash Book should, therefore, claim our first attention.

CASH BOOK VOUCHING

The vouching of the Cash Book is done to ensure:—

1. That all receipts and payments are duly accounted for;
2. That all such receipts and payments are entered under their appropriate heads of accounts;

3. That no unauthorised or fraudulent payment is made; and
4. That the closing cash and bank balances are correctly arrived at.

Before entering upon the audit of the Cash Book, the auditor should ascertain if the daily Cash Receipts are first recorded from day to day in a Diary of Cash Receipts. If this is so, he should check the daily totals of such Cash Diary and compare the record therein with the entries in the Cash Book. On the other hand, if a Rough Cash Book is maintained, he should at least apply some test checks to make sure that the entries in the Rough and the Fair Cash Books are identical and that the daily or the periodical balances tally.

He should further enquire what rule, if any, exists as to the lodgment of daily cash receipts, and whether the same has been strictly adhered to. An equally important enquiry would be to ascertain how the payments are controlled, who passes the payments, and who is authorised to sign cheques.

Where there are any internal regulations as to the authority for payments or form of acknowledgment, the auditor should see that these are rigidly enforced, and he should refuse to accept any voucher which is not duly authorised or is not acknowledged in the required form, without further enquiry.

RECONCILIATION OF BANK BALANCE

To begin with, all items on both the sides of the Cash Book should be checked in detail with the Bank Pass Book. Adjustments of contras in respect of cheques returned or bills receivable dishonoured, should be carefully seen; and items of interest debited or credited by the bank, bank charges and expenses of noting dishonoured bills should also be verified. The Bank Reconciliation Account should then be verified and the Bank Pass Book Balance tallied with the Bank Balance as per the Cash Book.

RECEIPTS SIDE OF THE CASH BOOK

Coming to the receipts side of the Cash Book, it should be noted that a loose system of acknowledging moneys received always invites fraud. It is, of course, impossible to eradicate in its entirety all chances of fraud, but much may be done. A special form of Counterfoil Receipt Book should be used, the receipts being printed with consecutive numbers. A receipt should be given from this book for every single item of cash received, and the number of such receipt should be entered in the Cash Book against each entry, in a special column provided for the purpose. Such a method facilitates reference and renders the auditor's work easy. In any case, where there is an adequate internal organization in regard to cash transactions, the auditor must feel considerably relieved that there would not be much chance for extensive leakages in this direction.

A practice is followed by some firms of sending out along with the cheques their specially printed Receipt Forms for acknowledgment and return by the payees. In such a case, it is highly desirable that the firm receiving the remittance should also send its own official receipt preferably from a Counterfoil Receipt Book and marked "Confirmatory Receipt", giving reference to the cheque. This will prevent the receiving firm from omitting to account for any of such receipts.

Where Counterfoil Receipt Books are used for acknowledging all amounts received, the following points should be borne in mind while vouching:—

(1) That all unused books are kept under lock and key, and the issuing of new books is controlled by some responsible official.

(2) That the dates, amounts and names on the counterfoils agree with the entries in the Cash Book.

(3) That spoilt receipt forms are not destroyed, but are attached to the respective counterfoils, and are initialled as cancelled by some one in authority.

(4) That no number is missing.

(5) That the discounts allowed accord with the usual terms of credit.

We now proceed to discuss the method of vouching the items of cash receipts under different heads.

CASH SALES.—The auditor's capacity for ascertaining that all cash which should have been received has been received is tested to the full in the matter of Cash Sales. Here, again, the auditor will have to rely to a great extent on the system of internal check in existence, and will have to regulate his methods of check accordingly. In business such as large shops, the auditor will find it extremely difficult to vouch them. A certain sort of check is afforded where cash registers are used, but this is by no means a sure one. The duplicate cash memo system has proved to be a good method. Under this system, a duplicate cash memo is made out for each sale, which duplicate is handed by the customer to the cashier, who keeps the same. Where this system is adopted, fraud cannot take place without collusion, and it is very rarely that collusion can be successfully worked. The auditor should check the cash sales memos with the daily Cash Sales Summaries, and trace the daily total of these summaries in the Subsidiary or General Cash Book, as the case may be.

PROCEEDS FROM HIRE-PURCHASE AGREEMENTS.—In regard to moneys received on account of Hire-Purchase Agreements, it should be seen that the amount of interest attributable to each instalment received is duly credited to Interest Account and not wrongly credited to Sales.

RECEIPTS FROM DEBTORS.—Equally important would be receipts from debtors on open accounts, i.e., those arising from Credit Sales. The

counterfoil receipt books will usually form vouchers for these. But the vouching of the amounts received from debtors is not so simple as it seems, for there are questions of discounts, allowances and bad debts to be considered. In dealing with discounts, it must be seen that only the usual percentage is allowed. A note should be made of such cases where special discount is allowed, and the fact must be inquired into. Where there is any special discount agreed upon, a note to this effect is generally found at the top of the respective Ledger Accounts.

If the auditor suspects the entry of any discount or allowance as being fictitious, he must immediately clear up his doubts by further enquiry, as fraud is usually perpetrated by crediting the amount to the customer's account as discount or allowance in order to make up for the misappropriation of the sum actually received and not accounted for.

INTEREST AND DIVIDENDS RECEIVED.—Interest will naturally come in at certain definite intervals; these intervals must be ascertained, and it must be seen that proper dividend or interest in respect of every investment has been accounted for on due dates. In regard to dividends received, the counterfoils of dividend warrants will be vouched with the entries in the Cash Book. If the investments are lodged with the bankers, credits for dividends or interest would be found in the Pass Book.

Interest on Deposits with Banks would be verified with the credits given in the Pass Books. Where interest is realised from any loan granted, the debtor's acknowledgment of loan or agreement should be seen to ascertain the rate of interest and the dates when such interest is payable.

RENTS RECEIVED.—As regards rents, all counterfoils of receipts must be traced into the Cash Book. If Rent Roll has been maintained, the rents received as shown therein must also be checked into the Cash Book, and it must be seen that all arrears have been properly accounted for. Leases or agreements with the tenants, if any, should be examined to ascertain the amount of rent receivable.

Any unusual allowance made to a tenant must be duly authorised, and arrears of rent long outstanding must be thoroughly enquired into.

COMMISSIONS RECEIVED.—All items of commissions received should be checked with the Commission Accounts that must have been rendered by the client to the parties from whom they were due.

Any commission received by the client for acting as a consignee will be vouched with the Account Sales submitted to the consignors.

AMOUNTS RECEIVED FROM AGENTS.—These should be verified with the accounts rendered by the Agents. It must be seen that such accounts are passed as correct by some responsible person.

BILLS RECEIVABLE.—All amounts received on discounting or maturity of Bills Receivable should be checked into the Bills Receivable Book. It must further be seen that all Bills that have become due are accounted for.

SALE OF INVESTMENTS.—Proceeds from sale of investments would be vouched with the broker's Sold Notes which will indicate the net amount receivable. Where investments are sold *cum div.*, it should be seen that the amount received is correctly apportioned between capital and revenue.

PROCEEDS FROM SALE OF LAND OR PROPERTY.—If assets like Land, Building, Plant or Fixtures are sold, such sale proceeds, would be vouched with the auctioneer's account, if it is a sale by auction, or would be proved by the production of sale contracts, correspondence or other documents relating thereto.

SHARE CAPITAL RECEIPTS.—The vouching of Share Capital has been exclusively dealt with in Chapter V.

PAYMENTS SIDE OF THE CASH BOOK

There must be a voucher obtained for every payment. In examining the acknowledgments for cash payments, the following points should be particularly observed:—

- (1) That the client is mentioned as the payer.
- (2) That the payee's name is properly stated in the Cash Book.
- (3) That the date, month and the year in the receipt agree with the corresponding entry in the Cash Book.
- (4) That the amount is properly entered in the Cash Book.
- (5) That the item of payment is duly authorised and is properly chargeable against the business.
- (6) That the amount is allocated to the correct account.
- (7) That the narration in the Cash Book sufficiently explains the nature of each entry.

The following usual items of cash payments will now be considered individually.

WAGES.—The vouching of this item would depend to a great extent on the nature of the system of internal check. It is not possible for the auditor to determine that the payments were actually made to the individual recipients shown by the wages sheets, and he need, therefore, concern himself with proving the payments in total. Where there is an effective system in existence, it is sufficient if the auditor sees that the wages sheets are prepared and checked by responsible members of the office staff. He should make careful enquiries into the methods employed in the preparation of the pay-rolls and the handling of the cash. The pay-rolls should be prepared by persons who do not have anything to do with the subsequent payment of the wages.

Ordinarily, the examination of the wages sheets by the auditor is limited to checking of the additions and to see that the wages sheets as a whole appear to be in order; that all clerks and officials who had anything to do

with the calculations or payment of wages have put their initials on the wages sheets and that these are countersigned by the works manager. It is desirable that the payment of wages should always be witnessed by the foremen of the respective departments and the works manager.

Where the wages are paid on piece-work basis, the auditor should satisfy himself after careful enquiry that a sound and effective system exists for the inspection and passing of piece-work, and that fines and penalties for defective work are duly adjusted before payment. He should also ascertain with reference to the Wages Sheets that cash advances to workmen, if any, and rent of hut, cost of materials supplied, etc., are duly deducted before the periodical payment of wages.

The auditor should also see that the amount of the wages cheque drawn for each month tallies with the total of the Wages Sheets for the corresponding month.

In short, the object of the auditor in verifying the item of wages is to satisfy himself that the payments as recorded were actually made, that they were properly authorised and were accurately ascertained. If there is any apparent lack of care in the office procedure which makes the auditor feel doubtful regarding the accuracy of the amounts paid or suspicious as to the possibility of fraud, he should have the payments checked in greater detail, and, if necessary, make a mention of such fact in his audit report.

SALARIES AND COMMISSION can be vouched with the Salaries and Commission Book, which would be initialled by those receiving the amounts. These should be scrutinised to see that any unusual increase is duly authorised. Calculation of commission may be tested in some cases.

The salaries of secretaries, managers or important officials would be fixed by the directors, and the Board's Minute Book should be consulted for the purpose.

Where the commission is paid by way of a percentage on the Sales, the agreement should be inspected to ascertain the exact terms of calculation. Usually, the percentage would be calculated on the Net Sales, i.e., after deduction of Returns, Allowances and Bad Debts, unless there is any stipulation to the contrary. In such cases, it is highly desirable that a proper record be maintained of the sales effected through each travelling salesman.

PAYMENTS FOR GOODS PURCHASED.—Cash purchases would be vouched with the Cash Memos received from the suppliers, and the auditor must satisfy himself that such purchases are duly authorised. In the case of payments to creditors on open accounts, the purchase invoices will have been checked while vouching the Invoice Book, and it will not, therefore, be necessary to examine these again while vouching the Cash Book. The receipts from the creditors acknowledging the amounts should prove sufficient for this purpose. The auditor should enquire whether periodical statements

received from the creditors are properly checked with the Ledger Accounts before being passed for payment by some responsible official.

TRAVELLING EXPENSES cannot, as a rule, be substantiated by vouchers, but are usually admitted by some one in authority. Where a limit is fixed in any particular case, the auditor should not pass any excess. The main question for the auditor would be whether such travelling expenses are necessarily incurred for the business and whether they are properly chargeable to the business. The agreements with travellers should be inspected to ascertain what the stipulations are as to travelling expenses.

In case of directors, it should be noted that they are not entitled to travelling expenses incurred for attending board meetings unless the company's articles specifically allow these or the company in general meeting so resolves.

MISCELLANEOUS ESTABLISHMENT EXPENSES.—Other payments for establishment expenses, such as Rent, Taxes, Insurance, Advertising, Lighting, etc., would be supported by well recognised vouchers. While vouching all these expenses, the auditor should carefully note the period covered to see if they would require adjustment or apportionment for the purpose of being included in the final accounts as outstanding liabilities or payments in advance.

RAILWAY FREIGHT AND CUSTOM DUTY.—The payments for railway freight, carriage and custom duty must be vouched with the accounts rendered by the authorities concerned. It should be seen that allowances in respect of rebate are properly brought into account.

PETTY CASH.—As to how far the auditor should vouch details of the petty expenditure is a question to be decided with due regard to the system in use. He must use his judgment in each particular case. If the Petty Cash Book is maintained on the Imprest System and is periodically initialled by the Cashier, it should go far towards satisfying the auditor that the payments are justifiable. The cheques issued for Petty Cash would be vouched with the Petty Cash Book. He should at least check all the vouchers for a period selected by way of test or see vouchers for all amounts (say) of Rs. 5 and upwards. Petty acts of pilfering almost constantly occur, and it is, therefore, difficult to lay down any hard and fast rule for vouching in this case. The auditor should see that no large amounts are paid through Petty Cash, and that the Petty Cashier is not allowed to receive any amounts however small except by way of Imprest Cheques. He should check casts and cross casts, and see that the expenditure is properly analysed and posted.

DIVIDENDS AND DEBENTURE INTEREST paid by companies should be vouched by checking the returned warrants with the Share Dividend and Debenture Interest Books. Unpaid Dividends and Interest should then be totalled and agreed with the bank balances as shown by their separate

Pass Books. In case of interest on bearer bonds, the cancelled coupons will form the vouchers.

BILLS PAYABLE honoured should be checked into the Bills Payable Book and verified with the actual Bills returned.

INVESTMENTS.—The payments for these would be checked with the broker's Bought Notes as also the securities themselves. Where the Investments are purchased *cum div.*, the proper allocation of accrued interest paid, if any, should be seen.

PATENTS AND COPYRIGHTS.—Such payments, should be verified with the contract for sale, and the voucher acknowledging the purchase consideration.

PLANT AND FIXTURES.—If bought from auction, the auctioneers' accounts would be checked, otherwise the receipt from the vendor will be seen. If these are acquired under a hire-purchase agreement, the auditor will have to see such agreement in addition to the voucher.

PAYMENTS UNDER HIRE-PURCHASE OR DEFERRED INSTALMENTS.—Where the payments are made under any Hire-Purchase or Deferred Instalments Agreement, the auditor should see that proper apportionment is made between principal and interest on recording payment or each instalment, and that under no circumstance is the asset account debited with anything beyond its present cash price. The payments are usually verified with periodical statements received from the hire-trader.

FREEHOLD AND LEASEHOLD PROPERTY.—In case of real property, the agreement for sale and conveyance together with the title-deeds will be vouched. Legal charges incurred in connection with the acquisition of the property and brokerage paid are allowed to be capitalised, and will be verified with the solicitor's bill of costs. If bought through auction, the auctioneer's accounts would be vouched.

If the building is constructed under a contract, the architect's certificates, the builder's receipts and the contract with the builder will be seen. Architect's Fees can also be capitalised.

PARTNERS' DRAWINGS may be verified with the Memorandum Drawings Book showing each partner's drawings from day to day and initialled by the partners.

BANK CHARGES as entered up in the Cash Book should be vouched individually with the Bank Pass Book.

POSTINGS FROM THE CASH BOOK

The vouching of the Cash Book having been completed, the auditor should check the postings in detail. From the debit side of the Cash Book, the postings would be checked to the credit of the various accounts concerned, and from the credit side, to the debit of the respective accounts. While check-

ing the postings, it should be seen that every item is posted to the correct Ledger Account concerned. The monthly total of the Discount Columns on the debit and credit sides of the Cash Book would be checked to the debit and credit sides of the Discount Account respectively. The checking of casts and carry forwards, and the Cash and Bank Balances at the close into the Trial Balance would complete the examination of the Cash Book. Where the Ledgers are self-balancing and the auditor is satisfied with the system of internal check in force, he need not necessarily check the whole of the postings to the Personal Ledgers, but may select a period by way of test and check all the entries of that period. If in course of such checking he does not come across any errors or irregularity, and if there is nothing to excite his suspicions, he may safely omit the postings of the rest of the period. It is desirable, however, that the whole of the postings into the Impersonal Ledger should be checked in detail.

PURCHASES JOURNAL

Turning now to the vouching of the Purchases Journal, it seems necessary in most cases to exhaustively verify the Credit Purchases by an inspection of Inward Invoices. While examining these Invoices, the following points should be carefully noted:—

- (1) That the Invoices are made out in the name of the client.
- (2) That each Invoice bears the initials of the persons who verified the receipt of the goods and who checked the accuracy of the rates and extensions, and of the manager who passed the same for payment.
- (3) That the date of the Invoice falls within the trading period under audit.
- (4) That the item is properly chargeable against the business.
- (5) That the creditor's name is correctly entered in the Purchase Journal.
- (6) That the net amount after the deduction of usual trade discount is entered.
- (7) That, if analysed, the analysis is correct, and if charged to capital the amount represents really an outlay on capital expenditure.
- (8) That each Invoice is stamped or initialed by the auditor after examination in such a manner as would prevent its being presented again for verification on some future occasion.

The vouching of purchase of materials or goods is a feature of prime importance to the auditor, but if the invoices bear evidence of having been properly examined and authorised, they go a long way to satisfy him.

The auditor should inspect the Goods Inward Book particularly for the last few weeks immediately preceding the close of the trading period, with a view to ascertain if the corresponding invoices for all such goods have been entered in the Purchase Journal. It would also be a good plan to examine

the Invoice File for the ensuing period to see whether the dates of any of those Invoices there relate to the period under audit. These steps are necessary in order to make sure that profits are not unduly inflated by the suppression of Purchase Invoices.

An independent check in this connection is to compare the percentage of gross profit earned on the cost of the goods sold with that of the previous period and if such rate of gross profit varies to any great extent, to enquire into the reason for it. It may be that the goods having been taken into stock, the corresponding Invoices have not been entered up in the Purchases Book.

A good check on the balances owing to the creditors can be obtained by the auditor suggesting his client to request the creditors to furnish him a statement indicating the balance due by the client at the end of the financial period. Where such statements are received, the auditor should verify these with the Ledger Balances and satisfy himself as to the correctness of the figures.

While vouching the Purchases Book, the auditor should most carefully guard against the same purchase being entered twice and the creditor's account being given a fictitious credit.

Where the Purchase Journal is of a columnar type, the auditor should ascertain that analysis is correctly made and the amounts are entered in their appropriate columns.

If any Invoice is allocated between capital and revenue, such allocation must be authenticated by some responsible official.

A list should be made of all Invoices missing or not available, and handed over to the management with a request to obtain duplicate. If any Invoice is not forthcoming and the entry cannot be supported by some satisfactory evidence of purchase, the auditor should not fail to mention the fact in his report.

Having touched the Purchase Invoices, the auditor should check the postings of the Purchases Journal to the credit of the accounts in the Bought Ledger, and the periodical totals of the book to the debit of the Purchases Account.

The casts and cross casts of the Purchases Journal should also be checked.

RETURNS OUTWARDS BOOK

The auditor should enquire into the system of dealing with such returns, and should verify the entries in the Returns Outwards Book with the Credit Notes received from the creditors. He would then check the postings to the debit of the various Creditors' Accounts and the periodical total to the credit of Returns Outwards Account. In case of exceptional items, or where he feels doubtful about the accuracy of the entries, he should call for the correspondence or the Goods Outwards Book, if any is maintained.

SALES JOURNAL

In regard to Credit Sales, the auditor should verify the correctness of the entries in the Sales Journal by a comparison with the duplicates of the Outward Invoices.

The auditor would do well to ascertain the method in force concerning the ordering and despatching of goods. The question as to whether it would be necessary or advisable to check the whole of the postings from the Sales Journal into the Sold Ledgers or merely test the postings of a certain period would depend on the system of internal check obtaining in the concern. For instance, if those in charge of the cash have no access to the Sold Ledgers, and if these Ledgers are independently balanced under the self-balancing system, the auditor may not find it essential to call over the whole of the postings.

The Sales Book for the last few weeks prior to the close of the trading period and the Returns Inwards Book for the subsequent period should be particularly examined, in order to ascertain whether any large quantities of goods shown as sold have been afterwards entered up in the Returns Inwards Book subsequent to the close of the period. Such a thing may be done purposely with a view to inflate the sales in order to increase profits or decrease losses.

In the event of there being any heavy sales at the close of the period, the auditor would do well to satisfy himself that all these goods had been delivered prior to the date of the financial close, and that none of these goods have been included in the closing stock.

The auditor should further see that goods sent by the client on "Sale or Return", and sales of goods received by him as a consignee are not passed through the Sales Book. If the sale consists of any old or discarded asset, the credit should go not to the Sales Account but to the particular asset account.

The possibility of omission of entries relating to a few sales with a view to cover up corresponding misappropriation of cash must not be overlooked by the auditor, and the system of internal check in use should be carefully scrutinised in order to ascertain how far there are any chances of such a fraud being perpetrated without detection.

Where goods on sale or return are treated like ordinary credit sales by being entered through the Sales Journal, the auditor should see that proper adjusting entries are made in respect of unsold goods lying with customers. He should further see that such goods are taken as stock and valued at cost or market price whichever is the lower.

The totals of the Sales Journal and the periodical postings to the Sales Account would, of course, be checked.

RETURNS INWARDS BOOK

The system of recording goods returned by customers and of issuing Credit Notes in respect thereof should be enquired into.

The entries in the Sales Returns Book will have to be checked with the duplicates of the Credit Notes issued. Some of the items may be tested with the Goods Returned Book, if any is kept. The postings should be checked to the credit of the customers' accounts and the periodical total to the debit of Returns Inwards Account.

BILLS RECEIVABLE BOOK

The auditor should trace each and every bill entered in this book. Such bills as are realised on maturity as also those which are discounted will be traced into the Cash Book. If any bill is dishonoured, he should see that the amount is transferred to the debit of the particular debtor's account. As to the bills unmatured and on hand, the auditor should actually inspect the same. If such bills are lying with the bankers for collection, he should obtain a certificate to that effect from the bankers. Thus, all the bills entered in the Bills Receivable Book will be accounted for.

The postings will then be checked to the credit of the individual customer's account and the periodical total to the debit of the Bills Receivable Account.

It should be seen that the balance on the Bills Receivable Account in the Ledger agrees with the total of the unmatured bills on hand.

BILLS PAYABLE BOOK

All Bills met by the clients would be traced into the Cash Book, and would also be verified with the returned bills. The postings would be checked to the debit of the individual creditor's account and the periodical total to the credit of the Bills Payable Account. The auditor should see that the total of the unmatured bills as shown by the Bills Payable Book tallies with the credit balance on the Bills Payable Account in the Ledger.

JOURNAL

The vouching of the Journal will require the strictest scrutiny of the auditor, as so many varied and important transactions are passed through this book. Of course, every entry in the Journal will have to be supported by a proper voucher initialled by some person in authority. The following transactions usually appearing in the Journal will be vouched as under:—

ALLOWANCES TO CUSTOMERS as also debits withdrawn or adjustments of debits on personal accounts would be verified with their respective Credit Notes duly initialled by some responsible official.

BAD DEBTS.—Documentary evidence would usually be available in respect of personal accounts writtch off as bad. Only certain authorised

officials must pass accounts to be written off as bad. In case of any doubt, the auditor must call for further evidence to satisfy himself that the debt was really irrecoverable.

DISHONoured BILLS.—Entries for these would be vouched with letters from the bankers intimating such dishonours.

CONSIGNMENT TRANSACTIONS.—Entries in relation to Outward Consignments should be vouched with the Account Sales received from the Consignees, and those in regard to Inward Consignments with the Account Sales despatched by the client to the Consignors.

In regard to Outward Consignments, if the goods are charged to the consignees at anything beyond the cost price, the auditor should see that necessary adjustments are made at balancing time in respect of the excess price charged, so that each consignment account may indicate the true profit or loss made thereon. The unsold stock with the consignees should be valued at the invoice cost price plus a proportionate charge in regard to expenses incurred by the consignors.

Where the goods have been received on consignment by the client, the auditor should see that the sales of such goods are not treated as ordinary sales, but are properly journalised. Where there are several consignments, it is always desirable to have a separate Consignment Journal for the record of all consignment transactions. It should also be ascertained on enquiring that the unsold balance of consignment stock held by the client is not treated as stock for balance sheet purposes.

SALE OR RETURN TRANSACTIONS.—Where the transactions of the nature of Sale or Return are numerous, a separate Sale or Return Journal is utilised to record such transactions. The auditor should ascertain that no debits are given to customers until they have accepted the goods. It should further be seen that goods unsold and remaining with customers at the close of the financial period are valued at cost or market price, whichever is the lower. If such goods have suffered any damage in transit, due allowance must of course be made for the loss thus occasioned.

TRANSFER ENTRIES.—All Transfer Entries from one Ledger Account to another must be very carefully scrutinised, and should be supported by proper vouchers authorising such transfers. In the absence of any direct voucher, the auditor should refer to the correspondence and any other material evidence to satisfy himself as to the correctness of the entries.

ADJUSTING ENTRIES.—While vouching the Adjusting Entries, the auditor should see that all outstanding liabilities in respect of expenses relating to the period under audit, income received in advance and income earned and not received are duly made. Adjustments in respect of expenses prepaid should also be closely scrutinised.

RECTIFICATION ENTRIES would necessarily be authorised by some responsible person, and must bear the counter-signature of the head accountant.

OPENING ENTRIES.—In case of a new company, the Opening Entries for the purchase of a business will be vouched with the Contract, with the Vendors, Company's Articles and the Directors' Minute Book.

CLOSING ENTRIES.—The Closing Entries will have to be checked to see that the correct closing balances are transferred to the right accounts.

SHARE CAPITAL ENTRIES.—Share Capital and Debenture Issue entries will be vouched with Application and Allotment Letters, the Minute Book, the Prospectus, the Company's Articles and the Registers of Shareholders and Debenture-holders.

CREDITORS' LEDGERS

The postings to the Accounts in the Creditors' Ledgers having been checked from the various subsidiary books, viz., the Purchase Book, the Cash Book, the Returns Outwards Book, the Bills payable Book and the Journal, the auditor will now check the castings of the Ledger Accounts.

The next step would be to check the balances on the Ledger Accounts into the Lists of Creditors. While doing this, the auditor would also see that no item is left off unticked on any of the Ledger Accounts.

If the Ledgers are maintained on the Self-balancing System, the total of the List of Creditors got out from each Ledger should agree with the balance shown by the corresponding Creditors' Ledger Adjustment Account in the General Ledger.

If statements from the creditors are received, they would present further evidence as to the correctness of the balances.

Where claims have been made by any creditors or the accounts are in dispute, or a law suit is pending, the auditor should see that an adequate provision is made for any liability in this connection. If such claims are of appreciably large amounts and are not provided for in the accounts, the matter must be at least clearly indicated on the face of the Balance Sheet by way of a note. If the provision already made is inadequate and the fact of a claim having been made is not disclosed in the accounts, the auditor must make a reference to this matter in his audit report.

In case there are debit balances on any of the accounts, the auditor must make sure that they represent items really recoverable.

DEBTORS' LEDGERS

The postings from the Sales Book, the Cash Book, the Returns Inwards Book, the Bills Receivable Book and the Journal having been checked into the Debtors' Ledgers, the castings of the Ledger Accounts would now be

checked, and the Ledger Balances would be examined with the Lists of Debtors.

If the Ledgers are Self-Balancing, the auditor should see that the total of the list of Debtors as ascertained from each Ledger agrees with the balance of the particular Debtors' Ledger Adjustment Account in the General Ledger.

While examining the Debtors' Ledger Balances, the auditor should make sure that all bad debts have been written off, and that a sufficient reserve has been provided for doubtful debts. If any debt appears to him to be doubtful by reason of its age or irregularity of receipts in reduction of the balance, or in view of a note made on the Ledger Account, such as, "in Solicitor's hands", "address not known", "adjudicated Bankrupt" or "in liquidation", etc., he should mark such balances on the List of Debtors. He should then go through the list of balances with a responsible official and ascertain what proportions have been provided against the debts, marked by him as doubtful. This would help him to judge of the adequacy or otherwise of the provision made in this respect.

It would be equally desirable for the auditor to obtain a certificate from the manager or some responsible official to the effect that the reserve made in this connection is, in his opinion, quite sufficient. In the event of debts of considerable amount appearing doubtful, in a Limited Company, the auditor would do well to write to the Board of Directors and ask for their opinion in this matter. In a partnership firm, the List of Debtors should be gone through with one of the partners.

A method which is frequently adopted in dealing with bad and doubtful debts is to create a reserve equivalent to a certain percentage on the total Book Debts at the end of the financial period by charging a corresponding amount to the Profit and Loss Account. All debts ascertained to be bad during the subsequent year are set off against this reserve, and then at the end of the year, the Profit and Loss Account is debited and the Reserve for Doubtful Debts Account is credited with such a sum as would bring up the reserve again to the fixed percentage on the then existing book debts. Where, however, the auditor finds that the sum doubtful of recovery is more than the reserve already appearing, he must insist on the reserve being brought up to an amount in excess of the percentage originally fixed so as to cover all likely losses under this head.

Where the Reserve made is inadequate in the opinion of the auditor, he should discuss the matter with those in management, and if after this, they refuse to modify the accounts accordingly, he should disclose this fact in his audit report.

It need hardly be pointed out that where the transactions are not checked in their entirety, a variation in the work done by the audit staff by changing the periods selected for test checks from year to year is highly desirable.

Settlement of accounts in Debtors' and Creditors' Ledgers by means of *contra entries* should be carefully vouched with their corresponding instructions and acknowledgments received.

If there happens to be any *bona fide* credit balances in the Debtors' Ledger, the auditor should see that they are not deducted from the amount of Sundry Debtors, but are included in the liabilities. Similarly, any *bona fide* debit balances in the Creditors' Ledger should be shown on the assets side of the Balance Sheet, and not deducted from the amount of Sundry Creditors. If such debit balances arise from payments made in advance against orders, they should be shown under the distinct heading of "advances against goods on order."

After the vouching of the entries in the various Subsidiary Journals has been completed and their postings checked into the Ledgers, it would be highly desirable for the auditor to carefully go over each and every Subsidiary Record as also the Ledger Accounts with a view to find out if there are any items left unticked. On any such items being traced, he should first determine why they have been left off unticked and then satisfy himself as to their genuineness.

The vouching of the various books of original record having been performed and the routine checking of the Personal Ledgers having been completed, there will now remain the more important part of the work, viz., the checking of the General Ledger and the verification of the Profit and Loss Account and the Balance Sheet, which is the subject matter of the next Chapter.

CHAPTER III

FROM TRIAL BALANCE TO BALANCE SHEET

GENERAL LEDGER

The Personal Ledgers having been exhaustively verified as explained in the preceding Chapter, the auditor will now enter upon the more important phase of the audit, viz., the checking of the General Ledger and the Trial Balance, and a critical examination of the Profit and Loss Account and Balance Sheet.

The postings from the various subsidiary books having been checked into the General Ledger, what now remains to be done is to check the casts and carry forwards of the Ledger Accounts and then check the balances into the Trial Balance. It is in the General Ledger that most of the information necessary for the construction of the final accounts would be found, and bearing this in mind, the auditor should use the utmost care, caution and skill in the handling of this Ledger.

An important part of the work in connection with the checking of the Debtors' and Creditors' Ledgers is that relating to the Opening and Closing Balances. The Opening Balances as appearing in these Ledgers should be checked individually into the Lists of Debtors and Creditors as made out at the close of the preceding period, and it should be seen that the aggregate totals of these also agree with their corresponding figures as shown in the last Balance Sheet. Similarly, the closing balances on Personal Accounts as appearing in the Ledgers should be checked individually into the corresponding Schedules, the respective totals of which should tally with the amounts shown in the Trial Balance as also in the current Balance Sheet under the headings of Sundry Debtors and Sundry Creditors.

While checking the General Ledger also, care should be exercised to see that the opening balances relating to the Asset and Liability Accounts are properly brought forward. Similar care will be necessary to see that the closing balances of all the accounts besides those of debtors and creditors are properly brought into the Trial Balance and thence into the Balance Sheet.

As a matter of fact, the closing balance on every Ledger Account must necessarily find its place in the Trial Balance. Whereas the accounts of the debtors and creditors being too numerous, their balances would first be entered on separate lists and the grand totals thereof would be incorporated in the Trial Balance, the balances of all accounts other than these would be entered straight in the Trial Balance. The auditor must, therefore, see that all the Ledger Balances are thus duly incorporated in the Trial Balance.

After the checking of the postings from all the Subsidiary Records into the Ledgers has been completed, the whole of the Ledger Accounts should be carefully examined to ascertain if there are any unticked items. If there be

any such items, they should be scrutinised closely. An unticked credit to a Personal Account purported to have been posted from the Cash Book might mean a direct credit in the Ledger Account to cover a sum received and misappropriated, and not entered in the Cash Book. An unticked credit appearing as having been posted from the Purchases Book might have been made directly to the Ledger Account in order to conceal a fictitious payment. A direct credit to a Customer's Account without its passing through any subsidiary record might sometimes mean an unauthorised discount, allowance or bad debt in order to cover up the corresponding cash received and misappropriated, or to set off a debit wrongly made. The auditor should, therefore, make thorough enquiries into any such items, before he satisfies himself as to their genuineness.

AGREEMENT OF THE TRIAL BALANCE

Not infrequently, the Trial Balance submitted to the auditor for verification shows a difference in the books, and the question that then arises is whether he can certify the accounts as correct even if such difference remains undiscovered. Of course, it is no part of an auditor's duty to find out differences in books, yet where a Trial Balance disagrees and the difference is of an appreciably large amount as would materially affect the final accounts, he cannot pass such accounts as correct unless the errors are located. Even where the difference is of a small amount, the auditor must make sure that it is not the outcome of several grave errors of a compensating nature remaining undiscovered, and if he is satisfied on this head, he can allow such difference to stand, but not until all the efforts on the part of the client's staff to localise the errors have been exhausted. In any case, it is not a safe practice to ignore difference in books, however small, and a prudent auditor would not rest satisfied till the books are brought in agreement.

An auditor is often asked as to the best means of localising clerical errors, and he is even called upon sometimes to assist in the search for a difference in the books, and consequently, the following few hints in this direction may be found helpful as a guide:—

(1) Assuming that the Trial Balance does not agree, the first thing would be to check the castings of the Trial Balance and of the lists of Debtors and Creditors, and then check the balances from the Personal and Impersonal Ledgers into the Trial Balance. While checking the Ledger Balances, care should be taken to see that they are properly extracted and entered in the right columns.

(2) A short cut would be to halve the amount of the difference to see if there is any balance of the same amount in the Trial Balance. It may be that the balance is entered in the wrong column of the Trial Balance, thus causing a difference of double the amount.

(3) If the difference is of a large amount, it would not be a bad plan to compare the Trial Balance with that of the previous year, in order to ascertain whether the figures under the different heads of accounts are very near the same as those of the previous year, and whether their balances fall on the same side of the Trial Balance.

(4) Very often, the amount of the difference will indicate the nature of the errors. If the difference is in round sum, it is probable that the mistake has been made in castings or in carry forwards. If it is in rupees, annas and pies, it is very likely an error or errors in posting or in extracting balances.

(5) The question as to on which side the difference falls will also help towards the localising of the errors. For instance, if the debits exceed the credits, the receipts side of the Cash Book and the credits from the Journal should be gone through for unposted items. If the difference is the other way about, the payments side of the Cash Book and the debits from the Journal should be scanned for unposted items. It may be that an amount exactly equalling the difference has been left off unposted.

(6) If the difference happens to be of an amount which constantly recurs in the books, all postings of this amount may be re-checked to advantage.

(7) The periodical postings from the various subsidiary books would then be checked into the Impersonal Ledger, after all the entries in these books are scanned for unticked items.

(8) It should be seen that the opening balances have been correctly brought forward in the current year's books.

(9) The Journal should be scanned to see that the total debits and credits of each entry tally.

(10) The casts and carry forwards of the various subsidiary books should next be checked.

(11) Where all these "short cuts" in localising the difference have failed, there will be no other alternative but to re-check all the postings and additions of the Ledger Accounts. While so doing, it would be advisable to re-check the additions and postings of the Impersonal Ledger before resorting to the Personal Ledgers.

(12) If the Ledgers are self-balancing, the work would be restricted to checking the balances, postings and casts of only that Ledger whose Trial Balance does not agree.

FINAL ACCOUNTS

The checking of the Trial Balance having been completed, the auditor will now proceed to examine the Profit and Loss Account. It is important for the auditor to see that the account is prepared in a manner as would

give a clear indication of the operating results and that the various heads of expenses and sources of income are properly grouped and classified.

TRADING ACCOUNT

In the case of a trader, the Profit and Loss Account would be divided into two sections, viz., the Trading Account and the Profit and Loss Account. The Trading Account would include only the items appertaining to the purchase and sale of goods and the stock-in-trade, if any, at the opening and close of the period. All direct charges such as Freight, Marine Insurance, Customs Duties, Clearing Charges, Dock Dues, Carriage Inwards, etc., incurred on the purchase of goods should be included in the Trading Account, as they form part of the ultimate cost of the goods. While including the closing stock, a proportionate part of such direct charges should always be added to the invoice price of the unsold goods.

ITEMS IN TRADING ACCOUNT

PURCHASES.—This item should include cash as also credit purchases of all goods bought for re-sale during the trading period. The gross purchases will appear in the inner column and the net amount after deduction of Returns Outwards in the outer column of the Trading Account.

It should be seen that all goods entered in the Purchases Book and remaining unsold are included in the Closing Stock.

Sometimes, invoices are received in advance of goods, and if the corresponding goods have not arrived before the close of the trading period, neither should such Invoices be entered in the Purchases Book nor should the goods be taken in the Closing Stock.

A point of equal importance is to see that all goods received and included in the stock are duly entered up in the Purchases Book.

PACKING MATERIALS.—Where the articles dealt in call for special packing of a costly nature, such packing charges would naturally be included in the sale price of the goods, and the cost of packing must therefore be treated as a charge to the Trading Account. Packing charges incurred in the ordinary way may be treated just like any other business expense and charged to the Profit and Loss Account.

FREIGHT, CARRIAGE AND CARTAGE.—Freight, Carriage and Cartage *inwards* on purchases of goods for re-sale are always looked upon as forming additional cost of such goods, and are, therefore, shown in the Trading Account.

On the other hand, Freight, Carriage or Cartage *outwards*, if incurred in despatching the goods to the customers, will have to be treated as a selling expense and will be charged to the Profit and Loss Account.

CUSTOMS AND EXCISE DUTIES.—Customs Duty is levied either on goods imported or exported. Excise Duty is one levied on indigenous products used for local consumption. If such duties are paid on purchases, they should appear in the Trading Account, whereas if they are paid on sales, they should be charged to the Profit and Loss Account and treated as a selling expense.

DOCK DUES AND CLEARING CHARGES.—Those incurred on Purchases would be shown in the Trading Account, and those on Sales in the Profit and Loss Account.

SALES.—This item should include all cash and credit sales of goods effected during the period. The gross sales should appear in the inner column and the net figure after deduction of Returns Inwards in the outer column on the credit side of the Trading Account.

In regard to the entries in the Sales Book a few days before the close of the financial period, it should be seen that the corresponding goods have been taken out of the bulk and delivered. In any case, goods entered as sold should not be treated as forming part of the Closing Stock.

PACKAGES AND EMPTIES

The auditor should carefully look into the method of recording these, more especially where they are returnable. Where these are not returnable, it is usual to include the charge in the sale price. Where returnable, it is always desirable to post the debits and credits in respect of these in separate columns so that it may be seen at a glance as to what amount worth of empties still remain to be returned. A special quantity record should be maintained of the incomings and outgoings of the empties or containers in a separate Register, and where these are of an appreciable amount, the auditor would do well to satisfy himself as to the adequacy of such record. The stock of empties on hand to be accounted for by customers must be duly certified by the clerk in charge as also by someone in authority. The question of depreciation must receive the auditor's most careful scrutiny, as these are liable to be handled roughly and are, therefore, subject to heavy depreciation.

FORWARD CONTRACTS FOR PURCHASES AND SALES

The practice in some trades such as the cotton and the woollen industries is to enter into forward contracts for purchases or sales of raw materials to be delivered at definite future dates. In case of a forward purchase, although a liability is incurred, such a purchase cannot be entered in the Purchases Journal until delivery is taken. Such purchases should, however, be recorded in a Forward Contracts Register in order to keep a record of the liabilities incurred. Similar considerations apply in case of Forward Sales Contracts. As these also cannot be entered in the Sales Book and treated as Sales till the goods are delivered, it is desirable that a separate record should

be maintained of all such forward contracts. It is never desirable to take profit on forward sales till the goods have been delivered, even where such goods may be ready for delivery. If, however, there is any likelihood of a loss arising on any such purchase or sale contract due to market conditions having become unfavourable, the auditor should see that the same is duly provided for. Where forward transactions are heavy, it may seem necessary for the auditor to insist on some note being made on the Balance Sheet in respect of the liabilities on forward contracts not having been brought into account, in order to portray the true state of affairs.

FORM OF TRADING ACCOUNT

As the object of the Trading Account is to indicate the gross profit, i.e., the profit arising from the buying and selling of goods, the following is suggested as the best form in which it may be presented:—

TRADING ACCOUNT

For the year ended.....

	Rs.	Rs.		Rs.	Rs.
To, stock at Com-			By Sales		
mencement ... ..	.....		(less Returns)		
„ Purchases (less					
Returns) ... ..	.....			
„ Freight ... ..	.....			
„ Duty ... ..	.....			
„ Carriage Inwards	.....			
Less Stock at					
close ... ..	.....			
Cost of goods sold	=	.....		
„ GROSS PROFIT	...	.....	
	Rs.	.....		Rs.	.....

By presenting the Trading Account in the above form, the cost of the goods sold is clearly indicated in one figure, and this figure comes in very useful for the purpose of ascertaining the percentage of the gross profit earned.

STOCK-IN-TRADE

The valuation placed on the closing stock must receive most careful attention at the hands of the auditor, as the correctness of the profit of any business would depend to a considerable extent on the accuracy with which this asset is valued.

The auditor does not take stock, and he has to depend upon the certificate signed by some responsible person as to the quantities having been correctly taken and the whole of the stock having been properly valued. He should, however, not accept such certificate from the management without applying checks or tests to satisfy himself that the asset has not been over-valued in any way.

The basis of valuation of stock-in-trade which has been generally accepted as sound and correct is that it should be valued at cost or market price whichever is the lower at the date of stock-taking. Due allowance must, of course, be made for old, damaged, depreciated or obsolete and unsaleable stock. A sound policy would be always to estimate the cost or the market value on a most conservative basis.

The auditor should check the casts of the stock sheets, check some extensions especially of big items, and verify the prices of some items by a reference to recent invoices.

He should ascertain that the basis of valuation adopted is reasonable and consistent from year to year. He should compare the total stock figure with that of the previous year and enquire into the cause of any large increase or decrease in the amount.

Another rough and ready test that may be usefully employed is to find out the percentage of gross profit made on the sales, and compare the same with similar rates of past years. If there is any unusual fluctuation, he should make further enquiries.

He should make sure that goods entered in the Sales Book are not also included in the closing stock, and that all goods taken in the stock are duly entered up in the Purchases Book.

He should further see that goods lying on Sale or Return or Approval with customers are not included at anything beyond the cost price.

Where proper quantity Stock Records are maintained, the auditor should compare a few select items to see whether the balances as shown by the Stock Books agree with the balances as ascertained on actual stock-taking, and enquire into the cause of any large difference.

Finally, he should see that the Stock Sheets are properly signed as to take prices, extensions and casts by the several members of the client's staff who were engaged on the work, and that the stock as a whole is certified as correct by one of the Partners, or the General Manager or the Managing Director.

Under no circumstance, should stock be valued at anything above cost, as this would result in anticipating profits which may or may not be realised.

The auditor having thus satisfied himself as to the accuracy of the Stock at the close of the period, would check the items of Opening Stock, Purchases, Sales, Returns Inwards and Outwards and Direct Charges from the Trial

Balance into the Trading Account. The Opening Stock must necessarily appear at the same figure as the Closing Stock of the previous period, and the auditor must see to this. As to the items of Purchases, Sales, Returns and Direct Charges, these will have been checked and scrutinised in detail while vouching the original records and checking the postings into the Impersonal Ledger, and the only thing that remains to be done now is to check these balances from the Trial Balance into the Trading Account.

COMPARATIVE SCRUTINY OF TRADING ACCOUNT

A comparative scrutiny of the various figures embodied in the Trading Account with similar figures of the previous period would help those in management to maintain a firm grip on the details of the business and would equally enable them to draw conclusions which might prove of inestimable value. In any case, such a comparison would inform them of the following points:—

1. Whether there has been any increase or decrease in the ratio of gross profit to turnover, and if so, how such variation can be accounted for. If the results disclose a steady decrease in the ratio of the gross profit from period to period, it would signify a sad state of affairs and would naturally call for urgent and drastic remedies.

2. To what extent the stock has been fluctuating, and whether such stock is maintained within legitimate limits.

3. Whether the buying has been judicious.

4. How far the sales are on the increase or otherwise.

5. Whether there has been any theft or leakage of goods.

Any one or more of the following causes may account for an **ABNORMAL INCREASE IN THE RATIO OF GROSS PROFIT** to the turnover: —

(a) The stock might have been over-valued due to a different basis of valuation having been adopted or due to errors in inventories.

(b) The purchase price during the period having remained constant, the sale price may have been enhanced; or the sale price having remained constant, the purchases may have been effected at cheaper rates.

(c) Goods may have been taken in stock, but the corresponding purchase invoices may not have been entered.

(d) Goods entered as sold but not delivered may have been inadvertently included in stock.

(e) Some sales may have been entered twice.

(f) A portion of some obsolete stock may have been written off in the preceding year, but no such adjustment may have been effected in the current year.

An **UNUSUAL DECREASE IN THE RATIO OF GROSS PROFIT** may be accounted for by any one or more of the following reasons:—

(a) Stock may have been under-valued.

(b) Whereas the sale price of the goods dealt in may have remained the same as in the previous year, the purchase price may have gone up; or the sale price having gone down, the purchase price may have remained the same.

(c) There might have been pilferings of stock.

(d) Some purchases might have been entered twice.

(e) Goods entered as bought may not have been received and thus not included in stock.

(f) Some sales moneys may have been misappropriated and the sales not accounted for.

(g) Goods sold and actually delivered may not have been entered in the Sales Book due to inadvertence.

(h) Some items may have been inadvertently omitted to be included in the stock.

(i) Some portion of stock found to be obsolete, unsaleable or shop-soiled may have been disposed of at a loss.

The auditor would thus see what a fund of most valuable information can be obtained by making a comparative scrutiny of the various items embodied in a Trading Account.

PROFIT AND LOSS ACCOUNT

The Gross Profit having been ascertained would be transferred from the Trading Account to the credit of the Profit and Loss Account, and against this gross profit would be set off on the debit side all the various expenses incidental to the conduct of the business and properly belonging and chargeable to the trading period under audit. It would be the duty of the auditor to examine each item of expenditure to see that it is an expense necessarily incurred in the course of the business, that it relates to the period under review, and that it is shown under a proper head.

While examining the Profit and Loss Account, greatest care should be exercised to see that a strict distinction between Capital and Revenue has been maintained; that revenue charges are not wrongly capitalised, or that items properly chargeable to capital have not been debited to revenue.

Since the object of the Profit and Loss Account is to show the true net profit or loss resulting from trading during any given period, it would be highly essential for the auditor to make sure that only the items of expenses and income appertaining to the period under audit are embodied in this account, and that proper allocations and adjustments have been made in respect of expenses prepaid or income received in advance. He should further see that items of expenses such as wages, salaries, rent, commission, etc., that belong to the period under review and have accrued due but have not

been paid, are all properly brought into account as outstanding liabilities by being charged to the appropriate nominal accounts. He should also see that any item of income such as interest or dividend on investments, rent, commission, etc., belonging to the period, that may have accrued due to the business but may not have been received at the time of balancing, is brought into account as accrued income by debiting Outstanding Income Account and crediting the nominal accounts concerned. All such adjustments and apportionments are made by means of Journal entries which should receive most minute scrutiny at the hands of the auditor.

OUTSTANDING LIABILITIES FOR EXPENSES

In arriving at the true amount of profit earned in any particular period, it is necessary to charge against it, not only the expenses which have actually been met, but also those which have accrued during the period and remain undischarged at the date of the accounts. The auditor should, therefore, scrutinise the various Nominal Accounts to see that the necessary adjustments are made in this connection.

A careful inspection of the Cash Book entries on the payments side for a few weeks immediately after the close of the period, will disclose the existence of any items of this nature which may not have been provided for.

PAYMENTS IN ADVANCE

It is equally important for the auditor to see that if any item of expenditure on revenue account is paid in advance for which no benefit has yet been obtained, a credit is taken for the proportionate amount representing the extent to which the benefit has yet to be received. Thus, the accounts for Telephone Charges, Subscriptions to Trade Periodicals, Fire Insurance, Advertisements, Municipal and other Taxes should be scrutinised to ascertain how far the payments under any of these heads are made in advance extending beyond the trading period, so that a credit may be taken for the proportionate amount belonging to the succeeding period.

INCOME ACCRUED AND NOT RECEIVED

Enquiry will also have to be made to ascertain if there is any item of profit such as rent receivable, interest on loans and investments, commissions, etc., earned, belonging to the period and not received, for if so, it is right and permissible that such credits be brought into account.

INCOME RECEIVED IN ADVANCE

It would be equally necessary to apportion any income received in advance in order that the Profit and Loss Account may get its legitimate credit for such portion only as appertains to the period under audit, the balance being carried forward as a liability.

ITEMS IN PROFIT AND LOSS ACCOUNT

SALARIES.—Under this item would be included salaries of the clerical staff and of travellers and managers. The whole of the salaries for the period under review must be brought in, and for this purpose, salaries, if any, due and not paid must be duly provided for. An inspection of the Salaries Book will help the auditor to ascertain any outstanding liabilities in this connection.

Salaries drawn by the Partners or the Proprietor of the business must be separately shown.

WAGES.—The auditor should ascertain from an inspection of the Wages Sheets that all wages due upto the last date of the financial close are brought into account. It need hardly be pointed out that Productive Wages will always appear in the Manufacturing or Trading Account, whereas only non-productive wages would find their place in the Profit and Loss Account.

RENT AND TAXES.—This item would include Office and Warehouse Rent and Municipal and other Taxes. It must be seen that Rent for the full trading period is brought into account, and if there is any outstanding, the same should be duly provided for.

If the amount paid for Rent, or Municipal and other Taxes extends over a period beyond the date of the financial close, only the amount relating to the period covered by the accounts need be charged to Profit and Loss Account, and the balance representing a pre-payment should be treated as a temporary asset in the Balance Sheet and carried forward to the next year's books.

Income-tax, if any, paid should be treated as a Personal Expense and charged to the Drawings Account of the proprietor, and not to Profit and Loss Account.

If any rent is received on sub-letting of office premises, it is desirable that the gross rent paid be shown on the debit side of the Profit and Loss Account and the amount realised from the sub-tenant be shown on the credit.

PRINTING AND STATIONERY.—Ordinarily, small amounts expended under this head for office stationery and printing are treated as business expenses and written off to Profit and Loss Account each year.

There are businesses, however, which have always a large stock of valuable catalogues and other printing matter and stationery unused at the end of each financial year. Such stock may be valued on a conservative basis and be brought into account as an asset in the Balance Sheet.

ADVERTISING.—All amounts expended under this head and relating to the period under review must be written off to the Profit and Loss Account.

If there be any advertising bills received and not paid, the same must be entered in the books so that the outstanding liability on this account may be brought into record.

If a payment in lump sum is made on account of an advertisement under a contract covering two or three years, the amount attributable to each year should be charged off to Profit and Loss Account as an expense, and the balance representing a pre-payment must be carried forward as a temporary asset.

If an abnormally heavy amount is expended in any one year with a view to advertise a product on a large scale, the same may be distributed over a number of years which it is expected would reap the benefit of the amount so expended. This point is further explained under the heading of Deferred Revenue Expenditure.

INSURANCE.—This item would include Premiums paid against Fire or Marine Risks arising in or attendant on business. Such payments usually cover one year's risk from the date of payment, and if any such payment extends beyond the financial year, the necessary adjustment in regard to the pre-payment must be made, the amount attributable to the succeeding period being shown as an asset in the Balance Sheet.

Premium paid in respect of a Life Policy of the proprietor must be treated as a personal expense and charged to the Drawings Account.

DISCOUNTS.—The item of Discount as is generally found in books of accounts relates to Cash Discount, and not Trade Discount. As has already been explained before, Trade Discount is always shown by way of deduction from the Purchase or Sale Invoice, and the original entry in the Purchase or Sales Book is of the net amount only after the deduction of Trade Discount. Evidently, therefore, Trade Discount will not appear in the books of accounts.

While showing the item of Cash Discount, it is always desirable to show Discount Receivable on the credit side of the Profit and Loss Account as a gain and Discount payable on the debit side as a loss, rather than strike a balance and show it on one side of the Profit and Loss Account.

INTEREST.—Interest Receivable and Interest Payable must be shown as separate items, the former on the credit side and the latter on the debit side of the Profit and Loss Account.

All interest either receivable or payable should be calculated to the date of the financial close and brought into account. If any gilt-edged securities are held by the business or if any loans are granted, interest accrued thereon to the date of the accounts must be taken credit for. Similarly, interest due on loans borrowed should be calculated to the date of the financial close, and the outstanding liability on this account, if any, should be brought in.

Interest on Proprietors' or Partners' Capital, if any calculated, must be shown separately from other Trade Interest.

COMMISSION.—Commission earned and Commission paid must be shown separately on the credit and debit sides of the Profit and Loss Account.

The outstanding liability in respect of Commission due and payable by the business to the date of accounts must be duly adjusted. Similarly, Commission earned to date of accounts and not received must be brought in as an accrued income.

TRAVELLING EXPENSES.—All amounts necessarily expended under this head on account of the business must be written off to Profit and Loss Account. Where Travellers are employed, their last bills in respect of all Travelling Expenses incurred up to the close of the financial period must be obtained and brought into record, even if unpaid.

REPAIRS.—All amounts expended in shape of repairs to existing assets such as Buildings, Fixtures, Plant, Machinery, Tools, etc., should be treated as expenses and written off to Profit and Loss Account. Extensive repairs of a non-recurring nature may be dealt with as explained under the heading of "Deferred Revenue Expenditure."

LEGAL CHARGES.—A thorough enquiry should be made to find out if any legal costs have been incurred during the period and the bills of costs received, for, if so, these should go into the accounts. Where any litigation is pending, the auditor should insist on the solicitors sending the client at least an estimate of the costs already incurred so that the amount may be provided for.

FORM OF PROFIT AND LOSS ACCOUNT

The exact form of Profit and Loss Account will have necessarily to depend on the nature of the business and the quantity and quality of the information the proprietors of the business would seek to obtain from the account. But, in any case, it is essential for the account to be so drawn up as to disclose the fullest information at a glance, as also to enable an easy comparison to be made of the various expenses and the sources of income with similar items of the previous periods.

The grouping and classification of the expenses and the income as shown in the Form appearing on the next page has been found in practice to be of considerable advantage as it conveys most valuable information in a readily comprehensible manner, and may be adopted by any concern with such modifications as may be necessary to meet the particular requirements of the business.

CRITICAL STUDY OF COMPARATIVE FIGURES

A careful comparison of the year's income and expenses under the various heads with similar items in the Profit and Loss Account of the previous year will give the auditor most valuable information and draw his attention to material differences. A critical study of the comparative figures of the Profit and Loss Account would also prove of immense benefit to those in manage-

[Continued on page 47]

PROFIT AND LOSS ACCOUNT

For the year ended.....

	Rs.		Rs.
To SELLING AND DISTRIBUTION EXPENSES:		By GROSS PROFIT	.....
Packing Charges	„ Cash Discount received	.....
Carriage Outwards	„ Income from Investments	.....
Export Charges	„ Interest on money deposited	.....
Cost of Samples	„ Interest on renewal of Bills	.....
Cost of Catalogues	„ Rent from sub-letting of premises	.....
Advertising	„ Income from any other source	.....
Travellers' Salaries, Expenses and Comm.		
Salesmen's Salaries, Expenses and Comm.		
Bad Debts		
„ MANAGEMENT EXPENSES:		
Office Salaries & Wages		
Office Rent & Taxes		
Office Lighting & Insurance		
Printing & Stationery		
Telephone Charges		
Postage, Telegrams, etc.		
Legal Expenses		
Directors' Fees & Expenses		
Managing Agents' Remuneration and Comm.		
Audit Fees		
Office General Expenses		
FINANCIAL EXPENSES:		
Cash Discounts allowed		
Cost of Discounting Bills		
Interest on Capital		
Interest on Borrowed Capital		
Loss in Exchange		
Discount on Issue of Debentures written off		
Preliminary Expenses written off		
MAINTENANCE AND DEPRECIATION:		
Repairs and Renewals	..		
Depreciation of Assets	..		
NET PROFIT	..		
	Rs.		Rs.

ment, as apart from disclosing any variation in the percentage of net profit from year to year, it would serve to indicate what increase or decrease there has been in the expenditure or income under any of the heads, and the reasons that account for such fluctuations.

DEPRECIATION

A further question for the auditor to consider while examining the Profit and Loss Account is that of depreciation. It is a matter of common knowledge that all fixed assets, such as plant, machinery, tools, buildings, leaseholds, wagons, furniture, fixtures, etc., gradually diminish in value as they get older and become worn out by constant use in the business. After a number of years, they become absolutely useless for the purpose for which they were originally intended and have then to be discarded and sold off at a break-up value.

In order that a trader or a manufacturer can arrive at a true amount of net profit made in course of a given period, it is necessary that such gradual loss by way of depreciation in the value of the assets should be provided for. The general principle that is observed in this connection is that all assets of a wasting nature should be written down in the books to their scrap value by the time they become useless for the purposes of the business. This is done by estimating the probable "life" of each asset and also the amount that would be realised on sale of that asset at the end of the period. The difference between the original cost and the estimated realisable value is then written off over the period during which it is anticipated the asset will be utilised in the business. In some cases, such as leaseholds, there is no realisable value, and the total cost has to be written off during the period of the lease.

DIFFERENT METHODS OF DEPRECIATION EMPLOYED

The following are the several methods employed for charging depreciation:—

- (1) Fixed Instalment Method.
- (2) Reducing Balance Method.
- (3) Annuity System.
- (4) Depreciation Fund Method.
- (5) Insurance Policy Method.
- (6) Revaluation Method.

FIXED INSTALMENT METHOD.—Under this method, a fixed proportion of the original cost of the asset is written off each year so that the asset account in question may be reduced to zero or its residual value at the end of a definite period representing its estimated life. This method can be usefully employed in case of assets like furniture and fixtures, short leases, etc., which involve little capital outlay, as the only thing that can be said in

its favour is its simplicity. The amount chargeable in respect of depreciation under this method is constant from year to year.

REDUCING BALANCE METHOD.—Under this method, depreciation is written off at a fixed rate per cent on the reducing balance of the asset account as appearing at the commencement of each year, so as to bring down the book value of the asset to its residual value by the time the asset becomes useless for revenue-earning purposes. This method is usually adopted in case of plant and machinery. As the fixed rate is calculated on the diminishing balance of the asset each year, it follows that the amount chargeable to revenue in respect of depreciation will become less and less as the years progress. It needs to be remembered, however, that in case of an asset of the nature of plant and machinery, the amount to be expended thereon annually in respect of repairs and renewals becomes heavier as the asset grows older. The advantage of this method of depreciation, therefore, lies in the fact that it tends to equalise the charge against revenue each year in respect of depreciation and repairs put together. For, whereas the amount of depreciation will be heavier during the earlier years, the same will be counter-balanced by the amount expended on repairs being lighter, and as the years progress, whereas the charge for depreciation will be on the down-grade, the amounts chargeable in respect of repairs will become heavier as the asset grows older.

ANNUITY SYSTEM.—Under this method, interest at a fixed rate is calculated on the capital outlay involved in the acquisition of the asset on the assumption that if the same amount of capital was employed in some other investment, it would have earned a certain rate of interest. The owner of the business, therefore, during the period that he utilises any asset not only loses the original cost of that asset in shape of depreciation, but also the interest thereon, and under the annuity system the cost of the asset as also the interest thereon are written down annually by equal instalments, until the book value of the asset in question is reduced either to zero or its residual value at the end of its usefulness to the business. The annual amount to be thus written off will be ascertained from the Depreciation Annuity Tables, and the following entries will have to be passed at the end of each year. Interest at a fixed rate calculated on the opening balance of the asset account will be debited to the Asset Account and credited to Interest Account. The fixed amount as ascertained from the Tables will then be debited to Depreciation Account and credited to the Asset Account. This method can be used advantageously, chiefly in respect of long leases which generally involve a considerable capital outlay. It will not be suitable for adoption in case of Plant and Machinery, as fresh calculations will have to be made each time any additions are made or any obsolete plant is discarded. Where it is desired not merely to write off an asset, but also to provide for its replacement at the time it becomes valueless, the Depreciation Fund System will be more suitable.

DEPRECIATION FUND SYSTEM.—This system consists of not only bringing into account the annual loss sustained by the shrinkage in value of

the assets utilised for the purposes of trade, but also provides fund for their replacement at the time when the old assets have to be discarded and have to be replaced by new ones, without in any way disturbing the financial condition of the business. The steps necessary to work this system are as follows:—

(1) Under this method, the asset account is allowed to stand in the books at its original cost from year to year. At the end of each balancing period, such a sum is debited to Depreciation Account and credited to Depreciation Fund Account which, if invested in gilt-edged securities from year to year during the life of the existing asset, will accumulate at compound interest to a sum required to replace the original asset at the time when it becomes useless.

(2) When a corresponding amount is invested in outside securities, the entry will be to debit Depreciation Fund Investment Account and credit Bank.

(3) The periodical interest realised on these car-marked securities will be debited to Bank and credited to Depreciation Fund Account and will also be invested in the same class of securities. The result of this procedure will be that by the time the existing asset has entirely worn out and has become useless for the purposes of the business, a fund will have been built up represented by specific securities which can be realised to supply the cash necessarily required to acquire a similar asset without in any way crippling the financial resources of the business.

(4) On the Investments being realised, the entry will be

Bank Account	Dr. ...
To Depreciation Fund Investment Account	...

(5) Any balance on the latter account will now represent profit or loss arising from the sale of these investments, and will be transferred to Depreciation Fund Account.

(6) The amount realised on the sale of the discarded asset will be credited to the Asset Account concerned.

(7) The Depreciation Fund Account will be closed by its balance being transferred to the Asset Account.

(8) Any balance now left on the Asset Account will represent an over or an under-estimate in respect of depreciation, and will be transferred to the Profit and Loss Account.

(9) The cash realised on the sale of the specific investments will now be available for the purchase of the new asset.

It needs to be mentioned that the amount which should be set aside each year to provide for the accumulation of a certain sum at compound interest at the end of a definite period is ascertained from ready-made Tables.

INSURANCE POLICY METHOD.—In some businesses, rather than investing the annual amount in gilt-edged securities to provide for the Depreciation Fund as above explained, a Policy will be taken out with an insurance company which will agree to pay a definite sum of money at the end of a specified period in return for a certain annual premium payable to them during the period of the policy. The entries under such a circumstance will be as under:—

- | | |
|--------------------------------------------------------------------------------|---------|
| (1) Depreciation Account | Dr. ... |
| To Depreciation Fund Account | ... |
| (To bring into record the annual loss arising from depreciation of the asset). | |
| (2) Depreciation Fund Policy Account | Dr. ... |
| To Bank | ... |
| (for the amount of annual premium paid). | |

Note.—The above two entries will have to be passed every year during the continuance of the policy.

- | | |
|--------------------------------------------------------------------------------------------------------------------------------------------------------|---------|
| (3) Bank Account | Dr. ... |
| To Depreciation Fund Policy Account | ... |
| (To record the amount realised on maturity of the policy). | |
| (4) Any difference on Depreciation Fund Policy Account will now be transferred to the Depreciation Fund Account. | |
| (5) Bank Account | Dr. ... |
| To the Asset Account | ... |
| (To record the break-up value realised on sale of the discarded asset). | |
| (6) The Depreciation Fund Account will be closed by transfer of the balance to the old Asset Account. | |
| (7) The balance on the old Asset Account, whichever side it may fall, will be transferred to Profit and Loss Account. | |
| (8) The cash realised on maturity of the policy will now enable a new asset to be acquired without disturbing the other cash resources of the concern. | |

REVALUATION METHOD.—This method is resorted to in case of assets which call for special considerations such as live stock, loose tools, patents, copyrights, patterns, casks, packages, bottles, etc., and where no other method can be employed to secure satisfactory results. At the end of each financial period, the assets are revalued, and the difference between the book value and the revaluation amount is debited to Depreciation Account and credited to the Asset Account. If, however, the revaluation figure represents an excess over the book value of the asset, the difference would represent profit, and such gain being of a temporary nature need not be brought into account.

AUDITOR'S DUTY AS REGARDS DEPRECIATION

The auditor need not concern himself with the method employed in writing off depreciation. His main duty would be to see that the question of depreciation of the assets is duly determined by the appropriate officials, that the probable life of each asset is estimated on sound and correct principles, and that the percentages written off from year to year duly provide for the book values of the assets being brought down to their likely realisable values at the end of their estimated period of usefulness to the concern. Where he finds on due enquiry that the provision made in respect of depreciation is inadequate, thus resulting in an undue inflation of profits, he should place the matter before the partners or those in management and induce them to remedy the defect. If after this, the final accounts are not altered to his satisfaction, he must unhesitatingly mention this matter in his audit report or qualify his certificate at the foot of the Balance Sheet accordingly.

MANUFACTURING ACCOUNT

In a manufacturing concern, it is necessary to sub-divide the Trading Account into two sections, the first section being styled Manufacturing or Production Account and the second Trading Account. The Manufacturing Account is prepared with the object of showing the actual cost of production of the Finished Goods during any particular period, and would include only the value of work-in-progress at the commencement and close of each period, the cost of raw materials consumed, the productive wages and all the other factory expenses.

The Form shown on the next page serves to disclose not only the cost of production but also the different component direct and indirect works expenses making up such cost, and is given as a specimen of the account ordinarily prepared by manufacturing concerns. The cost of production thus ascertained is transferred to the Trading Account which deals only with the items appertaining to Finished Goods, as illustrated on the next page.

VALUATION OF RAW MATERIALS AND STORES

As Raw Materials and Stores are held by a manufacturer not for the purpose of re-sale in their original condition, but to be utilised in the process of manufacture, the basis of valuation usually adopted is the cost price. The cost price for this purpose would be the net invoice price plus freight, duty, carriage inwards, etc. Under ordinary circumstance, even if the market price has fallen below cost, the value of the raw materials and stores in stock need not be brought down to that level. When, however, the fall in market price is appreciably heavy so as to affect the selling price of the manufactured products, it would be desirable to value these at market price.

MANUFACTURING OR PRODUCTION ACCOUNT

SHOWING COST OF PRODUCTION OF FINISHED GOODS

	Rs.	Rs.		Rs.
To WORK-IN-PROGRESS at commencement			By WORK-IN-PROGRESS at end	.....
„ DIRECT CHARGES:			„ COST OF PRODUCTION OF FINISHED GOODS.	
Cost of Raw Materials consumed			(Transferred to Trading Account)	.....
Productive Wages				
Chargeable Expenses				
„ INDIRECT CHARGES:				
Indirect Materials	.....		
Indirect Wages	.....		
Motive Power	.....		
Factory Rent & Taxes	.....		
Factory Lighting and Heating	.....		
Factory Insurance	.....		
Factory Repairs	.....		
Works Salaries	.....		
• Plant & Works Depreciation....	.....		
„ Interest on Capital Outlay in Works Building, Plant and Machinery	.....		
	Rs.		Rs.	.....

TRADING ACCOUNT

(of a Manufacturer)

	Rs.	Rs.		Rs.
To Stock of Finished Goods at commencement	..		By Sales	.....
„ Cost of Finished Goods transferred from Manufacturing Account	..		less Returns	.....
„ Purchases of Finished Goods (if any)	..			
Less Stock of Finished Goods at end				
Cost of Finished Goods sold=				
„ GROSS PROFIT transferred to Profit and Loss Account				
	Rs.		Rs.	.....

VALUATION OF WORK IN PROCESS OF MANUFACTURE

In case of goods in process of manufacture, i.e., partly-finished goods, the basis of valuation should be the actual cost of the direct materials consumed, direct labour and a reasonably fair percentage in respect of the factory oncost. It is not desirable, under any circumstance, to charge any percentage in respect of the selling, distribution and office oncost.

VALUATION OF FINISHED PRODUCTS

The basis for the valuation of Finished Products should also be the actual Factory Cost, same as in case of partly-finished goods. It is always sound and prudent not to add any percentage in respect of office oncost. An important point to be borne in mind while valuing finished and partly-finished products is that if the actual cost of these exceeds their market price, the market price should be the basis of valuation and not the cost price.

The auditor should satisfy himself as to the proper valuation of the finished and partly-finished goods by a reference to the Cost Sheets and must see that the percentage in respect of works oncost is correct in principle and is arrived at on some sound and equitable basis. Besides, he should obtain a certificate as to the correctness of the values placed upon the finished and partly-finished goods from the appropriate officials, such as the managing director or the general manager, the works manager and the head of the Cost Department.

VALUATION OF UNCOMPLETED CONTRACTS

Theoretically, it is not advisable to take into account profit on a contract until it is completed. In practice, however, in the case of Building Contractors, Shipbuilders, Engineers, and such like businesses, where a contract would take a number of years to complete, the ascertainment of profit is not left over till the contract is entirely completed, but the profit on the portion of work done from year to year is estimated on very sound and conservative basis.

There are no hard-and-fast rules as to at what stage it would be safe to take profit on an uncompleted contract, as so much would depend on the circumstances of each particular case. In no case, however, would it be sound to bring into account profit on a contract until it has advanced to such a stage as would enable a reasonable estimate to be made of the cost of completion.

When a contract has just commenced and has not reached such a stage as would enable the contractor to make a reasonable estimate of what it would cost him to complete the remaining portion, it is always prudent not to take credit for any profit made on the portion of work done. The amount expended on such a contract by way of materials consumed, direct labour and other direct charges incurred thereon will naturally appear on the debit of

such contract account, and this debit balance will be shown on the assets side of the Balance Sheet under the heading of Work-in-Progress.

Where a contract is far advanced and it is desired to bring into account profit on the completed portion of the work, a sound method that should be followed is not to take credit for the full profit as would be disclosed by the Contract Account, but to transfer to Profit and Loss Account only two-thirds or three-fourths of such profit and to carry forward the balance to next year's books. This is done with a view to provide for unforeseen contingencies such as future rise in the price of material or labour, or the contractor being called upon to pay heavy fines in case of failure to complete the contract within the stipulated time.

The auditor should examine most carefully the basis of valuation of such work-in-progress. He should enquire if proper Cost Books are maintained and whether there is any proper system of internal check on the materials issued out and the direct labour expended on the different contracts. He should also see that all likely contingencies are fully provided for before taking credit for any profit on partly-completed contracts. Finally, for his satisfaction, he should get the valuation of the work-in-progress properly certified by one of the partners, or the chief engineer, or some responsible official.

BALANCE SHEET

The last and the most important step in the completion of an audit is an exhaustive and minute examination of the Balance Sheet. The chief object of every Balance Sheet should be to disclose all the information necessary to enable one to form a true estimate of the financial condition of the business, assuming that the business is to continue as a going concern. As the true financial position of any undertaking is reflected by its assets and liabilities as indicated by the Balance Sheet prepared on any one particular date, it follows that these assets and liabilities should be most carefully valued for this purpose. Any over-valuation of assets or under-valuation or omission of liabilities would result in unduly inflating the profits. Similarly, any under-valuation or omission of assets or over-valuation of liabilities would tend to unnecessarily decrease the profits. The auditor should, therefore, see that all liabilities are fully and accurately set out and that the assets are not unduly or improperly inflated with a view to present better trading results than would be justified by the true state of affairs, or that the actual profits are not under-stated by the omission or under-valuation of assets or over-valuation of liabilities. He should further see that all the assets and liabilities are properly grouped and classified under appropriate headings, and that no material fact is suppressed or is presented in a manner as would create a false impression as to the state of affairs in the mind of one reading the Balance Sheet.

FORM OF BALANCE SHEET

There is no hard-and-fast rule as to the order in which the assets and liabilities of a sole trader or a partnership firm should be stated in the Balance Sheet. One method is to place the most easily realisable asset first and then follow it up by assets which are less easily realisable, so that the asset most difficult of realisation will be shown last. As against this order of the assets, the liabilities will be shown in the order in which they are payable, the most pressing liability being placed first. The Balance Sheet will then appear as under:—

BALANCE SHEET

LIABILITIES	Rs.	ASSETS	Rs.
Bills Payable	.....	Cash in Office	.....
Creditors for Loans	.....	Cash at Bank	.....
Creditors on Open Accounts	.....	Investments	.....
Outstanding Liabilities for Expenses	.....	Sundry Debtors	.....
Capital	.....	Bills Receivable	.....
		Stock-in-Trade	.....
		Loose Tools	.....
		Fixtures and Fittings	.....
		Plant and Machinery	.....
		Factory Building	.....
		Goodwill	.....
	Rs.		Rs.

The other method is to marshal the assets and liabilities in exactly the reverse order to the above, so that the fixed and permanent assets and liabilities appear first and will be followed by floating assets and liabilities. This arrangement now seems to be followed by almost all concerns except Banks and Financial Houses which prefer to show the liquid and floating assets first and follow them up with the fixed assets. It should be noted that while preparing the Balance Sheet of a Limited Company, it is this order of assets and liabilities that is required to be rigidly observed by the Prescribed Form of Balance Sheet under the Indian Companies Act.

VALUATION OF ASSETS

A Balance Sheet is not drawn up with a view to show what the capital of a concern would be worth if the assets were realised and the liabilities paid off, but rather to show how the capital stands invested at the end of each financial period. The values in the Balance Sheet are, therefore, not break-up values, but are ascertained on the assumption that the business is not to be wound up in the near future, but will continue to run its normal course.

As fixed assets are acquired not for re-sale but by way of permanent equipment to serve as a medium to enable the business being carried on, they should not be valued on the basis of the price they would realise if sold. The true basis of valuation for such assets would be their original cost, their probable "life", i.e., the estimated period of usefulness to the business and the likely break-up value. The difference between the original cost and the probable break up value would represent the loss to be suffered by the business on account of the use of such assets, and would have, therefore, to be equitably distributed over the estimated life of such assets. In other words, each fixed asset would be shown in the Balance Sheet at its original cost minus such accumulated depreciation or deterioration in value it may have undergone upto the date of the Balance Sheet. Floating assets, on the other hand, are held for re-sale with a view to profit or for immediate conversion into cash, and are, therefore, valued at the cost or the current market price whichever is lower at the date of the Balance Sheet. But both the fixed and floating assets should be valued on the basis of a going concern.

It is now proposed to deal with the different items which usually appear on the one or the other side of the Balance Sheet and to show the auditor's duties in connection with these.

CASH BALANCE

The actual cash in office as also the petty cash balance should be verified by actual count. All Chits and I.O.U.s. for temporary advances to employees should be initialled by some responsible person. Certificates should be obtained from the Branch Managers or the Agents in respect of cash remaining with them.

BANK BALANCE

The auditor should verify the Bank Reconciliation Statement with the Bank Pass Book, and also obtain a letter from the Bank certifying the Bank balance at the date of the Balance Sheet.

INVESTMENTS

The auditor should actually inspect the securities which may be represented by Certificates, Bonds, Allotment Letters or Scripts. The Investments may also be in shape of Inscribed Stock. The auditor should see that the Certificates or Bonds are made out in the name of the client. If the Bonds are to bearer, all coupons for the interest not yet paid must be attached to the Bonds. In case of Scripts, the auditor should see that they contain an acknowledgment of all calls so far paid by the client. As to the Inscribed Stock, this will be verified by getting a certificate from the Bank in whose books the Stock is inscribed.

It is a prudent policy to write the investments down to market value, if that is lower than the cost. If the temporary fluctuation in the market

value is ignored, the values on which the investments are based should be clearly stated in the Balance Sheet, as also should the market values.

DEBTORS ON OPEN ACCOUNTS

While checking the balances from the Debtors' Ledger into the List of Debtors, the auditor will have already marked the accounts appearing doubtful or overdue. He should now go through the List of Debtors with a responsible official to ascertain if sufficient reserve is made against Doubtful Debts. If it is usual for the client to allow cash discount on settlement of accounts within the period of credit, the auditor should also see that a proper Reserve for Discounts is provided for.

BILLS RECEIVABLE

The Bills in hand should be verified, or, if subsequently met, should be traced into the Cash Book. If the Bills are lodged with bankers, a certificate should be obtained from the Bank stating the amount of the Bills remaining unmatured and lying with them for collection. If any bill is overdue and not met, the auditor should see the transfer entry to the debit of the personal account and enquire if a proper provision is made for the likely loss on this account.

DEBTORS FOR LOANS

The auditor should verify the loans with letters from such debtors confirming the balances due by them at the date of the Balance Sheet. If the loans are secured, the securities should be inspected. Where such loans are not secured or the value of the securities does not fully cover the amounts advanced, the auditor should make further enquiries to ascertain if these are recoverable in full. If there is any likely loss, a provision should be made in this respect.

EXPENSES PREPAID

In order to vouch this item, the demand notes for the last payments in respect of Fire Insurance Premium, Telephone Charges, Taxes and Subscriptions to various Agencies, Newspapers, etc., should be scrutinised to ascertain that the proportion relating to the period after the date of the Balance Sheet to be carried forward in the next year's books is properly arrived at.

STOCK-IN-TRADE

The auditor should see that the Stock Sheets appear to be in order, that the stock has been taken and valued on some sound and consistent basis, and that it is certified as being accurately taken and valued by someone in authority. This item is further exhaustively dealt with in Chapter VI dealing with the verification of assets and liabilities of a Company.

PATTERNS AND DRAWINGS

A schedule should be prepared of these, and the auditor should satisfy himself that only the value of such Patterns and Drawings as are in fairly constant use is brought into the Balance Sheet. All Patterns which have been discarded or have become obsolete should be written off. It should be seen that amounts expended on Patterns and Drawings required for any special contract or job are charged off to that contract or job. In any case, this asset should always be valued on a most conservative basis.

PLANT AND MACHINERY

All original purchases of Plant and Machinery should be verified with their invoices together with the vouchers acknowledging the payments made by the client. If a round purchase price is paid for the whole of the business taken over, and the Plant and Machinery is only one of the several assets so acquired, the auditor should see that the allocation as to the purchase price of the Plant is made on some reasonable basis.

Where any fresh amount is added to the original purchase price, it should be seen that the addition really represents the cost of some new Plant purchased, and not a revenue charge in respect of renewals wrongly capitalised.

If any old or discarded Plant is sold, the auditor should see that the amount received is credited to Plant and Machinery Account and not to the Sales Account. If the book value of the Plant sold is in excess of the sale price, the difference should be written off as a loss.

The auditor should enquire if proper amount of depreciation is written off from year to year in addition to charging to revenue all repairs and replacements. He should see that the rates of depreciation are fixed by the engineer or the works manager in consultation with one of the partners.

LEASEHOLD PROPERTY

The auditor will have to inspect the Lease. If the property is mortgaged, a certificate should be obtained from the mortgagee stating the amount of the mortgage and the fact that the Lease is in his possession. As to depreciation, such an amount should be written off each year from the original cost as would extinguish the book value of the asset at the expiration of the Lease. All repairs and renewals should be charged to revenue each year. If there are any additions or extensions of a capital nature, the same may be added to the capital value of the Lease, but the total book value of the Lease should be reduced to zero by the time the Lease expires.

FREEHOLD PROPERTY

The Title Deeds should be inspected by the auditor, or if the property has been mortgaged, documentary evidence should be obtained of their

custody. The purchase consideration would be verified with the conveyance. The auditor should see that all repairs and renewals are charged to revenue, and proper depreciation is written off in respect of wear and tear of the buildings. If any fresh amount is added to the original cost of the building during the year under audit, care should be exercised to see that it represents actual additions or extensions. Where any fixed asset of the business is mortgaged, the auditor should see that a distinct note to that effect is made in the Balance Sheet immediately underneath the asset thus charged.

GOODWILL

Different opinions are held as to the treatment of Goodwill in accounts. There is no legal obligation to provide for the writing off of Goodwill out of revenue, and whether Goodwill should be so written off or not becomes a mere matter of policy. In a Partnership Firm, the auditor should consult the partners as to how they wish the Goodwill Account to be dealt with. If the auditor's opinion is asked for in the matter, he should advise the asset being written back to the capital accounts of the partners in their profit-sharing proportions, or a reserve being built against it during years of prosperity. If the client has purchased an established business and has paid for Goodwill along with other assets, the auditor should ascertain the cost of Goodwill from the agreement with the Vendor. The value of Goodwill of any business never remains constant as it is chiefly based on the earning capacity of that business. The auditor, however, need not concern himself with the fluctuations in the value of this asset as long as he sees that this item is not mixed up with any other asset, and the mode of its valuation is clearly indicated on the face of the Balance Sheet.

BANK OVERDRAFT

This would be checked with the reconciliation statement as also with a letter obtained from the Bank certifying the balance due by the client at the end of the financial period. The interest, if any, accrued due to the date of the Balance Sheet should be provided for.

SUNDRY CREDITORS

While examining the Invoice Book, the auditor will have made sure that no Invoice relating to the period under audit is left out. The statements from creditors made up to the date of the financial close should be examined by the auditor for all balances appearing in the List of Creditors.

BILLS PAYABLE

The auditor should compare the balance of the Bills Payable Account with the Bills accepted and not matured at the date of the Balance Sheet as shown by the Bills Payable Book.

CREDITORS FOR LOANS

The auditor should obtain letters from the creditors confirming the balances due to them on Loan Account at the date of the Balance Sheet. It should be further seen that all accrued interest up to the date of the Balance Sheet is brought into account.

OUTSTANDING LIABILITIES FOR EXPENSES

The auditor should ascertain that all liabilities for accrued and unpaid expenses such as Salaries, Wages, Rent, Commissions, Interest on Loans, etc., and belonging to the period under review have been duly provided for.

The verification of Assets and Liabilities has been lightly touched upon here as the same subject is exhaustively dealt with again in Chapter VI.

CAPITAL AND REVENUE EXPENDITURE

The distinction between Capital and Revenue Expenditure most vitally affects the fundamentals of accounting and it is highly essential, therefore, that the proper adjustment of these items must receive close and careful attention at the time of preparation of Final Accounts. In view of the fact that in so constructing the Final Accounts all revenue items would have to be included in the Revenue Account, i.e., the Profit and Loss Account, and all items of Capital Expenditure will form part of the Balance Sheet, it follows that this distinction would need to be most rigidly observed inasmuch as any incorrect adjustment or allocation in this behalf would falsify the final results as disclosed by both the Profit and Loss Account and the Balance Sheet.

The distinction between Capital and Revenue would thus form the very essence of an audit, and the auditor must most carefully vouch all additions to assets to ascertain that they really represent items of capital outlay, and that expenditure chargeable to revenue is not wrongly capitalised with a view to improperly inflate the trading profits.

Any amount expended which results in the acquisition of an asset, or which tends to extend or improve an existing asset, so as to enhance its revenue-earning capacity by increasing production or reducing cost of output may rightly be treated as Capital Expenditure. On the other hand, all establishment and other expenses incidental to the carrying on of a business for the purpose of earning revenue, such as Rent, Salaries, Taxes, Advertisement, etc., are instances of Revenue Expenditure. Further all expenses by way of Repairs and Replacements of existing assets which do not in any way add to their earning but simply serve to maintain them in their original state of efficiency are properly chargeable to revenue.

The following further points are worth noting in connection with capital and revenue charges, as they form exceptions to the general rule:—

LEGAL COSTS AND ARCHITECT'S FEES.—These are, as a rule, revenue charges; but Legal Charges and Stamp Duty paid for conveyancing on acquisition of a property and Architect's Fees paid for supervising construction of a property can be capitalised, as they form an additional cost of the asset acquired.

BROKERAGE AND STAMP DUTY.—Normally, these are revenue items; but brokerage paid on acquisition of a property or on purchase of shares, stocks or other securities, as also the stamp duty involved thereon can be treated as an additional cost of the purchase and capitalised.

PARLIAMENTARY EXPENSES.—Parliamentary Expenses incurred in promoting Bills for granting licences to Railways, Tramway Companies, Gas Works, Electric Lighting Companies and such other concerns, are capitalised under special Acts.

PRODUCTIVE WAGES.—This is a revenue charge; but in a manufacturing business where the firm's own men are employed in making extension to the factory building, or in erecting plant or manufacturing tools for own requirements the wages paid for such purposes would be capitalised.

REPAIRS.—Repairs and renewals are normally treated as items of revenue expenditure; but if an old property has just been acquired in a dilapidated state, and an amount is expended to put it into a tenable condition, the same can rightly be added to the cost of the asset. Similarly, if an old machine is purchased and a sum is spent by way of repairs and replacements to put it in running order and thus render it revenue-earning, the same can fairly be treated as an additional cost of the machine.

ADVERTISING.—Ordinarily, amounts expended on advertising own factory products or other goods dealt in with a view to enhance the sales, are chargeable to revenue. But where a newspaper concern expends abnormally heavy amounts on advertising in the beginning of its career, or where a manufacturing concern advertises largely its patented products at the initial stages of the business, this may have the effect of creating a future goodwill and may be capitalised.

INTEREST.—Although, ordinarily, a revenue charge, interest paid by public-utility concerns on subscribed capital, during construction of works, is allowed to be capitalised by statute, under certain terms and conditions.

FREIGHT AND CARRIAGE.—This is a revenue charge; but freight or carriage paid on newly-acquired plant or similar fixed asset will form additional cost of the asset in question and will be capitalised.

DEVELOPMENT EXPENSES.—In concerns like Collieries, Mines, Tea, Rubber and other Plantations, all expenses incurred during the period of development and upto the time they begin to earn are charged to Capital.

PRELIMINARY OR FORMATION EXPENSES.—These are initial expenses incurred in connection with the formation of a public company

and the obtaining of the share capital. These expenses, although revenue in their nature, are allowed to be capitalised and can be shown as an asset in the Balance Sheet, under the Indian Companies Act. There is nothing, however, to prevent their being written off against profits over a period of years, and it would be sound and prudent to do so, provided, there are sufficient profits to write these off.

UNDERWRITING COMMISSION OR BROKERAGE ON SHARES.

---These items are equally of a revenue nature as above, but are allowed to be capitalised and can be shown in a Company Balance Sheet as an asset, under the Indian Companies Act.

COST OF ISSUE OF DEBENTURES OR DISCOUNT ON ISSUE OF DEBENTURES.---This item represents expenses or loss arising at the time of issue of Debentures by a Public Company, and although revenue by nature, it is allowed to be temporarily capitalised and apportioned equally over the number of years for which the Debentures are to run.

ADDITIONS TO LEASEHOLD.---Addition to a Leasehold Building is a capital expenditure and can be debited to the Leasehold Account. But the cost of the original Lease as also the cost of additions thereto must be charged off to revenue equitably over the period covered by the Leasehold.

EXPENSES RELATING TO PATENTS.---All expenses relating to experimenting and subsequent acquisition of Patents including the Patent Agent's Fees are allowed to be capitalised, but the fee paid for Renewal of Patents is a revenue charge.

DEFERRED REVENUE EXPENDITURE

Where heavy expenditure of a revenue nature is incurred, the benefit of which is likely to extend beyond the year in which it takes place, it is customary and legitimate to allow such an expenditure to be temporarily capitalised and to be spread equally over the number of years for which it is anticipated the benefit would be enjoyed by the business. It need hardly be stated, however, that as to within what number of years the whole amount should be written off will depend on the circumstances attaching to each particular case. Items such as **PRELIMINARY EXPENSES, BROKERAGE ON SHARES** and **COST OF ISSUE OF DEBENTURES OR DISCOUNT ON ISSUE OF DEBENTURES**, as explained above, may well be classed under this head. Further instances of Deferred Revenue Expenditure items are:—

(a) **COST OF REMOVAL OF BUSINESS** to a more convenient locality.

(b) **COST OF REMOVAL OF WORKS** and the incidental expenses incurred in connection with the **DISMANTLING, REMOVING** and **RE-ERECTION** of plant and machinery.

(c) **EXCEPTIONAL REPAIRS** of a non-recurring nature by way of overhauling of the entire plant or a section thereof.

(d) ADVERTISING payment made under a contract extending over a term of years or an abnormally heavy amount expended on advertisement in any one year in order to popularise a new product.

In all such cases, inasmuch as the benefit to be derived from the amount expended would last for a number of years to come, it is deemed sound and equitable that each of these years concerned be burdened with a proportionate share of such expense, and not that the whole amount be charged off to the revenue account of the very year in which it had been so expended.

STRUCTURAL ALTERATIONS

Where structural alterations are made on a property to satisfy local bye-laws, but which do not in any way add to the revenue-earning capacity of the asset in question, or where alterations have to be made on a roof to prevent leakage of rain water, the amount spent should be charged to revenue. Thus, if additional emergency exits have to be constructed in a theatre under the rules of local authorities, the cost should be charged to revenue. But where alterations are done to any existing plant whereby its efficiency or capacity is increased, such a cost may fairly be capitalised. Similarly, if a theatre or a cinema-hall is re-furnished or structural alterations are done thereto whereby its attractiveness and comfort are considerably added to, so as to result in additional revenue, the amount expended will be treated as Capital Expenditure; but if the expenditure is by way of re-painting and putting the property in thorough repairs, the same must be charged off to revenue, although an abnormal amount having been spent in this manner may be treated as a Deferred Revenue Expenditure item and spread over a reasonable number of years.

ALLOCATION BETWEEN CAPITAL AND REVENUE

It happens sometimes that an amount is expended on an existing asset, and whereas the whole of it cannot on the one hand be treated as capital expenditure, it cannot equally be dealt with in its entirety as a revenue charge. Under such a circumstance, it will have to be most carefully apportioned between capital and revenue, and for the purpose of such a dissection, the basis of apportionment would be as follows. To the extent to which the expenditure results in enhancing the revenue-earning capacity of the existing asset, it can safely be treated as capital expenditure and the balance may be charged off to revenue. In so dissecting the expenditure, it has always been regarded as sound and desirable to err on the safe side by charging a proportionately larger sum to revenue than would be justified from the results, in order that the asset account concerned may not be shown in the books at anything more than its real value. A good illustration on this point may be quoted. Some extensive alterations were done recently to a Cinema Theatre Building. Apart from important structural alterations, the entire property was put in thorough repairs, and the interior of the theatre including

the sitting accommodation was absolutely re-furnished and made more attractive and comfortable. This resulted immediately in a substantial increase in revenue. A careful analysis of the total sum expended elicited the fact that only 16% of the total expenditure related to repairs and repainting and that 84% represented improvements to building and cost of re-furnishing. It was then decided to treat 20% of the entire expenditure as a revenue charge and to capitalise 80%. The book value of the old assets abandoned had naturally to be written off, but as this sum as also the 20% to be charged to revenue amounted to an abnormally heavy burden on the Profit and Loss Account, the same had to be distributed over a period of three years.

NEW WORKS REPLACING OLD WORKS

There are occasions when old works have to be pulled down and re-instated by new works of greater earning capacity, or the existing plant has to be discarded due to new inventions and replaced by one more costly and efficient. Such a circumstance would call for a careful adjustment between capital and revenue, and the important point to be decided is, "should the loss represented by the book values of the assets discarded be considered as part of the cost of new equipment and capitalised"? In such a case, the one method usually followed is to capitalise the entire present cost of new equipment, and to charge off to revenue the book value of the old asset *plus* the cost of dismantling, *less* the proceeds from the sale of old materials and the value of old materials utilised in new construction. A more conservative method would be to charge off to revenue the PRESENT COST OF REPLACEMENT and to capitalise only the ACTUAL BETTERMENT. Assume that a tramway company converts its horse traction into an electric traction, and an enormous amount of loss is sustained due to the horses and the old rolling stock having had to be disposed off at any price realisable. Would it be sound and proper to capitalise such a loss by treating it as forming part of the cost of new equipment? Opinion on this matter unfortunately is divided, but it may safely be said that although the legality of such a procedure may not be questioned, it can never be said to be a sound policy to follow from the view-point of finance. In fact, it is never sound to permanently capitalise an amount which is not represented by any tangible asset. But the amount of loss arising from the old assets which have to be discarded being abnormally heavy need not necessarily be charged off to revenue in any one year, but may be distributed over a reasonable period of years. Where such a replacement does not result in any increase in the revenue-earning capacity of the business, the whole of the cost of renewal may be treated as a revenue charge and may be spread equitably over the number of years for which it is estimated the benefit of such replacement will be felt.

The following list of items chargeable to Revenue and those chargeable to Capital will be found useful:—

ITEMS CHARGEABLE TO REVENUE

1. All expenses incurred in the ordinary conduct and administration of the business, such as Rent, Salaries, Wages, Insurance, Advertising, etc.
2. Expenses incurred by way of repairs, renewals and replacements for the purpose of maintaining the existing permanent assets of the business, such as Works Building, Plant, Machinery, Tools, Fixtures, etc., in a state of original working efficiency.
3. Cost of Goods bought for re-sale.
4. Cost of Raw Materials and Stores acquired for consumption in course of manufacturing.
5. Wages paid for manufacture of products for sale.
6. All other amounts expended in the manufacturing and distribution of the products handled.
7. Loss arising from wear and tear and obsolescence of assets utilised in business.
8. Annual amount to be written off the Lease.
9. Interest on Loans borrowed for business.
10. Loss arising from the sale of Fixed Assets.
11. Annual Fees paid for renewal of Patents.
12. Maintenance of Office Car or Motor Van including replacement of Tyres, Tubes, Wheels, etc.
13. Maintenance of Electric Lights and Fans.
14. Book values of assets discarded or totally damaged or destroyed by fire or other reasons.

ITEMS CHARGEABLE TO CAPITAL

1. Cost of Goodwill.
2. Cost of Freehold Land and Buildings, and the legal charges and stamp duty in connection with conveyancing.
3. Cost of Lease acquired.
4. Cost of Plant, Machinery, Tools, and Fixtures acquired for equipment.
5. Cost of Trade-Marks, Patents, Copyrights, Patterns and Designs.
6. Cost of Office Car, Motor Van or Lorry.
7. Cost of installation of Lights and Fans.
8. Cost of any other asset acquired by way of equipment.
9. Expenses on erection of Plant and Machinery.
10. Actual additions and extensions to existing assets.
11. Structural improvements or alterations to existing assets whereby their revenue-earning capacity is increased.
12. Development Expenses in case of Mines and Plantations.

13. Administration Expenses in industrial enterprises incurred during period of construction and equipment.
14. Cost of experimenting when the same results ultimately in acquisition of a patent.

PARTNERSHIP AUDIT

The auditor to a partnership firm is appointed by the mutual consent of all the partners, and it would be his duty to give equal consideration to the interest of each individual partner. It would be in his own interest to see that his appointment and its confirmation are set down in writing. His first duty on appointment would be to get himself fully acquainted with the terms of the Partnership Agreement.

As there is no scale of fees fixed by any Statute, the question of Auditor's Remuneration in case of professional work done for a sole trader or a private partnership must necessarily depend upon the terms arranged by express agreement. Where it is not possible to make a fair estimate of the fee at the time of employment, the auditor may at least fix some basis on which his remuneration would be calculated in order to obviate any dispute and consequent unpleasantness afterwards.

SPECIAL MATTERS IN PARTNERSHIP AUDITS

The auditor will have to consult the Partnership Deed on the following additional matters in order to ascertain that the Final Accounts he has to certify are prepared in accordance with the terms thereof:—

- (1) The Capital to be contributed by each partner and the maximum amount each partner is allowed to withdraw in anticipation of profits.
- (2) Whether the Capitals and Drawings are to carry interest, and, if so, the rate per cent.
- (3) The interest to be allowed on Loans by Partners, if any.
- (4) The arrangement as to the division of Profits or Losses.
- (5) Whether any partner is entitled to any salary prior to the division of profits, and whether any provision is to be made for any reserves before the ascertainment of profits.
- (6) The respective duties of the partners and the restrictions on their powers, if any: also which partner is authorised to draw or endorse cheques, bills, etc., and pass Invoices and Statements for payment.
- (7) How further capital, if necessary, is to be introduced.
- (8) The basis on which to determine the amount payable to a retiring partner or the representative of a deceased partner in respect of capital and accrued profits since the last accounts.
- (9) The basis of valuation of the goodwill of the firm, if any, as also the other assets, for the above purpose.

(10) How any capital loss arising from the insolvency of any of the partners is to be borne.

MUTUAL RIGHTS OF PARTNERS IN ABSENCE OF AGREEMENT

Under the Indian Partnership Act, 1932, the mutual rights and liabilities of partners have been laid down as under:--

- (a) A partner is not entitled to receive remuneration for taking part in the conduct of the business;
- (b) All partners are entitled to share equally in the profits earned, and shall contribute equally to the losses sustained by the firm;
- (c) Where a partner is entitled to interest on the capital subscribed by him, such interest shall be payable only out of profits;
- (d) A partner making, for the purposes of the business, any payment or advance beyond the amount of capital he has agreed to subscribe, is entitled to interest thereon at the rate of six per cent per annum ;
- (e) The firm shall indemnify a partner in respect of payments made and liabilities incurred by him---
 - (i) in the ordinary and proper conduct of the business, and,
 - (ii) in doing such act, in an emergency, for the purpose of protecting the firm from loss, as would be done by a person of ordinary prudence, in his own case, under similar circumstances; and
- (f) A partner shall indemnify the firm for any loss caused to it by his willful neglect in the conduct of the business of the firm.

Under the ENGLISH ACT, the rate of interest payable to a partner advancing money to the firm is 5 per cent, IN THE ABSENCE OF ANY AGREEMENT TO THE CONTRARY.

CAPITALS OF PARTNERS

There is no implied obligation in law that partners must bring capital in equal or in any stated proportions, and the matter rests absolutely with the partners to decide. It is even not necessary that every partner must contribute something towards the firm's capital, and instances may be found where a partner is admitted into a firm without his introducing anything by way of capital. The capital of a partnership firm as originally determined by agreement may be increased from time to time by further contributions and by undrawn profits, or may be decreased by withdrawals and losses, or the proportions of capital as originally determined may be altered, by the mutual consent of all the partners. Such consent need not be expressed in writing but may be tacit and proved from the conduct of the parties. Further, the capital to be contributed by each partner need not necessarily consist of cash

payment, but may be satisfied by the introduction of assets other than cash, such as Stock-in-Trade, Fixtures, Plant, etc., by mutual agreement.

DRAWINGS OF PARTNERS

The partnership Deed generally includes a clause allowing each partner to withdraw a certain amount at each periodical interval in anticipation of his share of profits. Such withdrawals are debited to a separate Drawings Account of each partner. Whether such drawings are chargeable with interest is again a matter of arrangement between the partners. In many cases, where the capitals bear interest, the drawings are not chargeable with such interest.

SHARING OF PROFITS AND LOSSES

The proportions in which profits or losses arising from the business are to be divided will depend upon the agreement between the partners. In the absence of any such agreement, even where the capitals are in unequal amounts, the partners will be deemed by law to be equal sharers in profits or losses on the ground that the Court cannot be expected to enter into questions of partners' merits. It may be that a partner contributing a very small portion towards the firm's capital may bring into the business special skill which cannot be measured in terms of money, and by virtue of this attribute he stands to share as much out of the profits as another partner who has contributed a much larger sum in the shape of capital, but who is not possessed of the requisite skill. Again, one partner may be taking an active part in the conduct of the business, and the others may not be. It is evidently, therefore, left for the partners themselves to decide as to what would be the most equitable mode of sharing profits and losses. Where the Partnership Deed provides for the profits being shared in a particular manner and there is no mention of how the losses should be borne, the assumption is that these should be borne in the same proportions. Further, it is quite legal and competent for the partners to arrange for the profits to be divided in certain proportions and the losses to be borne in quite other proportions. It is equally competent for the partners to agree to exempt any one or more of them from bearing any losses.

INTEREST ON CAPITAL

Where the capitals are contributed in certain proportions and the sharing of profits or losses is not in proportion to capitals, interest on the capital of each partner is generally calculated at an agreed rate per cent, and is considered as a charge on the Profit and Loss Account, before the ascertainment of net profits. It must be remembered, however, that no such interest on his capital can be claimed by any partner as a matter of right, in the absence of an agreement to that effect. Where the capitals are unequal, but the profits are shared equally, the partner with larger amount of capital

would otherwise be at a disadvantage and the one with smaller capital would benefit at the expense of his co-partners; again, where the capitals are equal, but the profits are shared in unequal proportions, the partner taking the largest share of profits would otherwise get an undue benefit over the others, and the adjustment in regard to interest on capital will tend to lessen the inequality. It is thus clear that the allowance of interest to each partner on his respective capital will tend to balance the accounts equitably amongst the partners *inter se* or, in any case, serve to compensate the partner with larger capital contribution. Even where the profits are shared in the same proportions as the capitals, it is usual and desirable that interest on capital be brought into account in order to enable the partners to see what profit they have realised from the business over and above the interest they would have earned if the same capital were invested in gilt-edged securities.

INTEREST ON DRAWINGS

Where the partnership agreement provides for the allowance of interest at a certain rate per cent on the capitals of the partners, it does not necessarily follow that such interest should be calculated on the drawings. If it is desired that interest should also be charged on the drawings, there should be a distinct mention to that effect in the agreement. Where the capitals and the sharing of profits are equal and the drawings are in unequal sums, interest is usually charged on the drawings by mutual arrangement in order that the accounts of the partners may be equitably adjusted *inter se*. As has been said above, the question of interest on capital and drawings is purely a matter of agreement between the partners, and the partnership accounts will have to be prepared with due regard to the terms and conditions of such an agreement, if there exists any.

PARTNERS' SALARIES

It frequently happens that one of the partners may be devoting his entire time to the business whereas the others may not, and under such a circumstance, it is usual to allow the former an agreed salary before the ascertainment of the net profit. The practice of allowing salary usually obtains in a firm where there are junior partners with hardly any capital contribution who take a very small share of the profits and yet who devote the whole of their time and energy to the business. When such salaries are drawn out in cash from month to month, they should be charged to Partners' Salaries Account. Where, however, lump sums are withdrawn at irregular intervals on account of salaries, these would be debited to the Drawings Account of the partner concerned and an adjustment would have to be made at the end of each financial period, debiting Partners' Salaries Account and crediting the Drawings Account of the partner with the annual amount of salary due to him.

LOAN BY A PARTNER

Any advances by a partner by way of loan will carry 6 per cent interest by implication (IN ENGLAND 5 per cent), unless otherwise agreed upon; and this is irrespective of the fact whether the capitals bear any interest or not. But the partners by mutual consent may agree to allow a higher or lower rate of interest on such loan, in which case such agreement will hold good. A partner can claim a repayment of his loan, in the absence of any agreement to the contrary, although he cannot ask for a refund of his capital. In case of a dissolution, such loan by a partner would rank to be repaid in priority to the refund of capitals, but after the claims of all outside creditors are satisfied in full. Loan by a partner must be credited to a separate account from his Capital Account and must be distinctly stated in the Balance Sheet.

FIXED CAPITALS

Where it is stated in the Partnership Deed that the Partners' Capitals shall be fixed and shall be maintained at the same figures during the partnership, the Capital Account of each partner would be credited with only the actual contribution to capital. No adjustment will then be made on the Capital Accounts, and the balance on each such account will remain at the same figure from year to year, representing the original capital contribution. In this case, instead of the Drawings Account, there will be a separate Current Account of each partner, and the withdrawals by each partner would be charged to this account. The adjustments at the end of each financial year in regard to Interest on Capital and Drawings (as may be arranged) and share of profit or loss will all be made on the Current Accounts of the partners. The Current Account of each partner will then be closed by balance, and will be shown quite distinct from the Capital Accounts on the Balance Sheet. A credit balance on such Current Account left after all the above adjustments would mean that the partner has not withdrawn the whole of the profits and the interest on his capital due to him, and he may draw this balance any time he chooses. A debit balance, on the other hand, would signify that the partner has overdrawn his share of profits and interest to the extent of such balance and he may be required either to refund this excess withdrawal or make good this debit balance by reducing his future drawings.

Where the Capitals are agreed to be fixed quantities, the balance on the Current Account of each Partner must be shown as a separate item in the Balance Sheet. If such an account shows a debit balance, it will fall on the assets side of the Balance Sheet and, if it shows a credit balance, it will appear as a liability.

DUTIES IN PARTNERSHIP AUDITS

The auditor in a partnership firm should always be on the look-out to ascertain that nothing is done by any one partner to the detriment of the

other partners. He must watch equally the interests of all of them, and should determine by careful enquiries that all the requirements of the Partnership Deed or any other terms outside the Partnership Deed as may have been mutually agreed upon by the partners have been fully fulfilled. He should be faithful in the discharge of his duties to all the partners and should ensure after an exhaustive and skilful scrutiny of the books, vouchers and documents available that the accounts he certifies do represent a true picture of the state of affairs of the firm.

As disputes in matters relating to accounts frequently arise amongst the partners, it seems highly advisable for the auditor to first discuss the draft Final Accounts in the presence of all the partners and to take full notes of any points raised by any of the partners and the ultimate decision arrived at by all of them. For his own protection, if there has been any variation from the terms as originally agreed upon in the Partnership Deed in respect of either the sharing of profits, salaries to partners, drawings, interest on capitals and drawings, or capital contributions, he should state the fact in a report attached to the Balance Sheet specifically indicating the deviation from the agreement and making a pointed reference to such Report underneath the Balance Sheet above his signature. In the same report, he should state whatever items he wishes to make clear before the partners, so that he may not afterwards be held responsible by any of the partners for not having drawn their particular attention to any point of importance.

The auditor should enquire if any minutes are maintained recording the decisions of the partners on important matters, and, if so, refer to these to ascertain if there are any resolutions affecting accounts.

Where there is any doubt as to the exact interpretation of any clause in the Partnership Deed, he should consult the firm's solicitors in the matter, with the consent of the partners.

Finally, the auditor should impress upon the partners the desirability of all of them signing the Balance Sheet, so as to prevent all chances of disputes in the future in matters of accounts.

GOODWILL IN PARTNERSHIPS

Occasions often arise when an auditor has to check adjustments in respect of Goodwill in partnership books, and it is thought, therefore, that a discussion of the several modes of dealing with Goodwill may not be out of place here.

In the absence of any agreement between the partners to the contrary, Goodwill is always a partnership property and it goes with the business. But although it may exist in every well-established business, it always remains an unrecorded asset and is never brought into visible shape unless an occasion arises when it becomes necessary to value it. It is, in fact, a silent asset which always jointly belongs to the partners and its valuation forms an

important item of adjustment amongst them whenever there is any change in the constitution of the firm. It is thus brought into account (a) on the admission of a new partner, (b) on the retirement or death of an existing partner, (c) on the dissolution of the business piecemeal or (d) on sale of the business to a Limited Company.

GOODWILL ON ADMISSION OF A NEW PARTNER

It is important to note that once a person is admitted into partnership, he becomes entitled to share in all profits and gains arising from the date of his entry irrespective of whether such profits accrue from the trade or from an amount realised on the sale of an asset in excess of its book value, or from the sale of an asset which does not so far appear in the books, unless such new-comer is precluded from taking a share arising from any particular source by express agreement. Thus, if after the admission of a partner the goodwill of the firm is realised, the new-comer along with the other partners will be entitled to claim his share thereof, unless it can be shown that under an express arrangement he was not to share in such profits; and, it will be no answer for this purpose to say that he had paid nothing for his share of goodwill at the time he entered the partnership. If it is desired that he should have no interest in the firm's goodwill, it is perfectly competent for all the partners to make an agreement upon the admission of a partner that the latter should have no interest in the firm's goodwill.

TREATMENT OF GOODWILL ACCOUNT ON ADMISSION OF A NEW PARTNER

Where the Goodwill amount is brought in cash by a newly admitted partner, it belongs to the existing owners of the business and they are entitled to share it in their profit-sharing proportions. If at the time of entry of a new partner, the existence of goodwill is admitted by all, but if the new-comer does not bring his proportionate share thereof in cash, it becomes necessary to bring goodwill into record at its full agreed value in the partnership books in order that the old proprietors may take their legitimate credit in respect of this asset which has resulted from their own past efforts, and which had so far remained unrecorded.

The method of treating Goodwill in the books of accounts varies considerably.

(1) It may not be brought into the partnership books at all and may be paid by separate cheques to the old partners by the new-comer, and thus treated as a matter outside the business; or

(2) It may be recorded as received in the books of the firm, but may be drawn out immediately in cash by the old partners in their profit-sharing proportions; or

(3) The amount received may be entered in the firm's books and retained in the business as additional capital, after the old partners' capital accounts have been credited with their legitimate shares; or

(4) The Goodwill amount may not be brought in cash by the new-comer, but a Goodwill Account may be raised and the Capital Accounts of the old partners may be credited with their respective shares.

It may be mentioned, however, that it is to the advantage of the newly admitted partner to see that the amount paid by him for Goodwill is brought into record in the firm's books, and that it may not be withdrawn but is allowed to remain in the firm in proportionate credits to the old partners' Capital Accounts so as to leave so much more working capital in the business.

But because Goodwill has had to be brought into record for a definite purpose, viz., for adjusting the Capital Accounts of the existing partners before the admission of a new partner, it is not necessary nor is it desirable that Goodwill Account should be allowed to remain in the firm's books. It can once more be treated as an unrecorded asset, and written back to the Capital Accounts of the partners. In so writing back the Goodwill Account, it should be debited to the Capital Accounts of all the partners including the new-comer in their NEW PROFIT-SHARING PROPORTIONS, for it will be in these proportions that the partners will share the future profits including the profit arising from the sale of goodwill.

GOODWILL ON RETIREMENT OR DEATH OF A PARTNER

On the retirement or death of a partner, his share of Goodwill will have to be valued in accordance with the terms of the Partnership Deed. In the absence of such a provision in the agreement, the retiring as also the continuing partners will have to come to a mutual understanding as to the amount to be credited to the retiring partner in respect of his share of Goodwill.

The mere fact that the Goodwill was not valued and included amongst the assets in the periodical Balance Sheets of the partnership whilst it was a going concern, would be no argument on the part of the continuing or surviving partners to refuse to give to the retiring partner or the representatives of a deceased partner his due share of the value of Goodwill, whatever that value may be.

In order to avoid disputes and the consequent litigation which are so commonly experienced between the surviving partners and the representatives of the deceased partner, it is highly desirable that the Partnership Deed must include clauses clearly defining the manner in which the amount due to a deceased partner's estate is to be ascertained and how the accounts of the partners *inter se* are to be adjusted under such a circumstance. Such an agreement must indicate the procedure to be adopted in regard to the following matters:—

1. The basis of arriving at the deceased partner's share of profits from the date of the last Balance Sheet to the date of his death;
2. Whether the Capital of the deceased partner is to be taken at the balance standing on his Capital Account at the date of death; or whether the assets of the firm are to be revalued for the purpose of adjusting the deceased partner's Capital;
3. The basis of ascertaining the value of Goodwill in order that the Capital Account of the deceased partner may be credited with his proportionate share thereof; and
4. The mode of payment of the deceased partner's share.

Where any such procedure is laid down in the partnership agreement, the auditor should see that the same is rigidly followed in ascertaining the ultimate amount payable by the surviving partners to the legal representatives of the deceased partner.

There are two distinct ways of dealing with Goodwill for the purpose of crediting the outgoing partner with his due share thereof, thus: --

(1) By bringing Goodwill into record at its full value and giving the corresponding credit to each partner's Capital Account (including the outgoing partner) in their respective profit-sharing proportions; or

(2) By debiting Goodwill Account and crediting the outgoing partner's Capital Account only with the sum representing his share of Goodwill.

Where Goodwill is brought into record at its full value, it may or may not be maintained permanently as an asset in the partnership books. There can be no legal objection to its being retained in the books and shown as an asset in the Balance Sheet at the same figure from year to year, if the partners so decide to do, and provided it is shown as a separate item under its distinct heading. From the view point of sound finance, however, it may not be deemed desirable to allow an asset of such a fluctuating character to stand in the Balance Sheet at its original figure from year to year, and the partners may decide to write it back to the Capital Accounts of the continuing or surviving partners in their *future* profit-sharing proportions.

Where, however, Goodwill Account is debited with such a sum only as is necessary to credit the outgoing partner's Capital Account, it would be fundamentally wrong to allow this account to show as an asset in the Balance Sheet, as the debit balance, in this case, will represent only a fractional value of Goodwill. Under such a circumstance, the balance on Goodwill Account should be immediately written back to the Capital Accounts of the continuing or surviving partners in their *future* profit-sharing proportions.

Sometimes, the partners decide to spread the value of Goodwill over a number of years, and the important point to be borne in mind in such a case is to see that the corresponding charge is made on the Capital Accounts of the partners and not on the Profit and Loss Account. It would be wrong

in principle to charge Profit and Loss Account each year with the amount to be written off Goodwill, for if such a procedure were followed, the Profit and Loss Account will fail to reflect the true working results of each trading period.

GOODWILL ON DISSOLUTION OF PARTNERSHIP

Upon a dissolution of partnership, arising from any cause whatsoever, every partner has a right to have the Goodwill of the firm realised along with the other assets for the common benefit of all the partners. If the business is taken over by one of the partners who intends to carry it on in the same old name, the value of Goodwill will have to be determined in accordance with the basis, if any, as laid down in the partnership agreement, and where no agreement exists, by mutual understanding amongst the partners. The amount as then agreed upon as representing the Goodwill value, will have to be debited to the purchasing partner's Capital Account and credited to Realisation Account.

Where the entire business is taken over by a Limited Company, the value of Goodwill, if any, would be included in the amount of purchase consideration agreed upon. The Purchasing Company would in this case be debited with the total amount it has agreed to pay (inclusive of Goodwill) and the Realisation Account would be credited with the same, in the partnership books.

The auditor's duty in connection with any adjustment made in respect of Goodwill would be to see that it is made in accordance with the agreement between the partners and that the accounts of the partners *inter se* are equitably adjusted.

CHAPTER IV

INTERNAL ORGANIZATION AND CONTROL

GENERAL CONSIDERATIONS

The question of internal check in force in a business has such a direct and important bearing upon the work of an auditor, that an attempt has been made in this Chapter to indicate a general outline on which a sound system of internal organization and control may be designed to suit the requirements of any business.

THE OBJECTS TO BE AIMED AT IN ANY SUCH SYSTEM ARE:—

(1) To render the chances of successful fraud on the part of any member of the staff more difficult.

(2) To ensure the speedy detection of any dishonesty or irregularity.

(3) To provide for the detection of errors at the earliest possible moment so as to reduce to its minimum the inconvenience or loss thus occasioned to the owner of the business.

(4) To make it possible to place indisputable responsibility for each detail of the work on a definite person.

(5) To make sure that all facts and transactions that affect the financial position of the undertaking are duly and promptly recorded in the books of prime entry; and that the entries thus made are afterwards properly dealt with in the Ledgers so as to ensure their true effect being brought into record.

(6) To so shape the system of accounting as to enable an easy balancing of the books and the prompt preparation of the financial statements.

FUNDAMENTAL PRINCIPLES

In framing any system of business organization with a view to discourage fraud by rendering its early detection inevitable, the following fundamental principles should be borne in mind:—

(1) No one person should have absolute control over operations of an important and far-reaching character. Thus, the general business manager should be relieved of all responsibility in connection with accounts; and the accounts department should be independent of every operating department, but at the same time, in close and direct touch with the head of the management.

(2) The same person shall not be allowed to manipulate uncontrolled the financial operations of the concern or to certify year after year the value of stock-in-trade or book debts. A scrutiny of the most notable frauds in recent years reveals one outstanding fact, viz., that they have been the result of placing too much confidence and trust in one person. Nearly all frauds

are committed by "trusted" officials or employees; in fact their opportunities for fraud have arisen through their being trusted.

(3) All officials and employees who have the handling of cash, securities or stock, or who are concerned with the keeping of accounts should be required to take an annual holiday so as to prevent their having uninterrupted control of any part of the work.

(4) The respective duties of each member of the staff should be properly arranged and clearly defined so as to be able to fix definite responsibilities on each person.

(5) Wherever possible, the work of the members of the staff should be varied from time to time. Such a shifting of duties is a very important part of any sound system of organization, as it is the only effective safeguard against collusion.

(6) All modern mechanical devices such as, cash registers, recording clocks, duplicating office methods, calculating machines, etc., should be introduced so as to place difficulties in the way of fraud.

(7) It should be so arranged that the work of each employee is checked by others. If this is done, fraud cannot take place without the complicity of several persons, and collusion seldom works successfully. Besides, if such checking is done at frequent intervals, fraud or errors cannot remain long undetected.

(8) Method and thoroughness must characterise the whole working of the business, and laxity or procrastination should on no account be tolerated.

(9) Every transaction should pass through several hands in a well-defined manner, and there should be a written record of the part played by each employee.

(10) All the books, vouchers and documents should be so classified, filed and linked together as to admit of easy reference.

(11) The integral sections of the business should be so interlinked one with the other that the entire business may run with the least possible friction and in most complete harmony.

(12) The clerical labour involved should be reduced to a minimum, and the system introduced should be simple, workable and effective.

It must be made clear at the outset that no set of rules for internal organization and control may be framed so as to be made equally applicable to every concern, as so much would depend upon the nature, size and scope of each business. The following general rules may, however, be employed in any undertaking with necessary modifications so as to suit the particular requirements of each business.

CASH TRANSACTIONS

Probably, the most numerous frauds committed by the employees are by way of defalcations by cashiers and petty cashiers, and it is necessary, therefore, that the system of control in this direction should be carefully planned and most rigidly followed. Experience has shown that where a cashier is permitted to receive money, retain it for an indefinite period, and use it, if necessary, to pay accounts, etc., and at the same time is allowed to make entries in the other subsidiary books or Ledgers, there would be ample opportunities for him to falsify the accounts, if he be so minded.

It would be easy for him in such circumstances to receive money from a customer and not record it, misappropriate the amount and write off the debit balance on the customer's account as a discount or a bad debt or an allowance for overcharge; or to make an entry of a fictitious purchase in the Invoice Book, credit the amount to a Personal Account in the Ledger, enter a fictitious payment in the Cash Book, and misappropriate the sum. Such items of fraud cannot, of course, remain long undetected as they would surely be discovered by a careful auditor. But, as it always pays a business man to prevent fraud rather than allow it to be perpetrated and then seek to discover it, it would be worth while to consider by what means such defalcations by the cashier can be prevented, or, in any case, rendered more difficult.

The following rules may, therefore, be laid down to be observed in connection with cash receipts and payments.

CASH RECEIPTS

(1) All letters should be opened by or in the presence of some responsible person, and all cheques or postal orders enclosed therein should be crossed in the name of the firm and marked "Not Negotiable." A list should be made of all such remittances before handing them over to the cashier, and the same should be compared at frequent intervals with the Cash Book.

(2) All cash, cheques, etc., received should be forthwith entered in the Cash Book and paid intact into the Bank from day to day.

(3) Specially printed Receipt Books with counterfoils should be used to acknowledge all amounts received; and no receipt should be given on invoices or statements.

(4) The following rules should be observed to secure the best advantage from the use of Counterfoil Receipt Books:—

(a) All unused Receipt Books should be kept under lock and key.

(b) The receipt forms and counterfoils should bear printed consecutive numbers.

(c) Spoilt or cancelled receipts should not be destroyed but must be attached to their respective counterfoils.

(d) After a receipt is made out and before it is torn off from the book, it must be presented to the person authorised to sign such receipts, whose duty it would be to compare the contents with the counterfoil, and initial the same.

(e) Any alteration of the amount or the name on the counterfoil should bear a further initial of some authorised person.

(f) Customers should be requested to make payments by cheques drawn in favour of the firm and crossed, and notice should be given that no receipt would be valid unless given on the firm's printed form.

(5) The Receipt Numbers should be given against their respective entries in the Cash Book in a special column provided for the purpose.

(6) Whenever the size of the business warrants it, the actual handling of cash and securities and the signing of cheques should be done by a different person from the one who writes up the Cash Book.

(7) The cashier should not be allowed to make entries in any of the Ledgers or in any book of original entry other than the Cash Book.

CASH SALES

There should be a carefully planned system of control over cash sales in retail businesses and large cash stores, and such concerns must equip themselves with Cash Registers, with secret total attachments for additions and devices for tabulating the sales of each salesman and of each department.

In large stores where extensive cash sales take place daily and a large number of shop assistants are employed to effect sales, a system that has been found to work most satisfactorily is as follows:—

(1) Each assistant is identified by a letter or a number, and is supplied with a Sales Memo Book containing three sets of 50 or 100 Sheets numbered consecutively. Each Book would bear the letter or number of the assistant using it and would be accompanied by carbon sheets.

(2) Sales Memo Books used by different departments may be printed on different coloured paper, so as to facilitate analysis.

(3) As each sale takes place, the assistant enters up the details in the Memo Book supplied to him, and two carbon copies are taken out simultaneously. The book is then presented to some senior assistant who initials the memo to indicate that the items are properly charged and extended.

(4) Two copies of the Sales Memo with perforations are then torn off and handed over by the sales assistant to the customer, who hands over the cash to the cashier whose desk is situated just near the entrance to the Stores.

(5) In some instances, the customer tenders the payment to the salesman, who enters up the amount tendered on the Sales Memo and hands over the same to the cashier, who in this case, occupies the central position of the department.

(6) On receipt of the two copies of the Sales Memo, the cashier initials one copy and hands over the same to the customer or the sales assistant with any change, as the case may be. The other copy, he files on a separate file allocated to that particular assistant.

(7) One copy of each Sales Memo remains with the salesman in his book, and at the end of each day, after entering up the amount of each such memo in a Summary Sheet provided at the end of the book, he passes on that copy to the counting-house for the purpose of being checked with the Cash Sales Sheet sent by the cashier.

(8) At the end of each day, the cashier also enters up a Cash Sales Sheet indicating the distinctive numbers of the Cash Memos he receives during the day and their respective amounts, with analytical columns showing the total sales effected by each assistant.

(9) The total amount of Cash Sales for the day thus shown would be entered in the General Cash Book after the Cash Sales Sheet is verified with the Sales Memos filed by the cashier and also by the sales assistants.

(10) The whole system is most rigidly enforced and all discrepancies are immediately enquired into and thus located without much delay.

(11) Another check on such transactions is provided by the sales assistant not handing over the parcel of goods to the customer but passing it on to separate packing clerks. The customer will then have to receive his parcel from the counter placed just near the exit on presentation of the Sales Memo.

COLLECTION BY TRAVELLING SALESMEN

The system of allowing Travelling Salesmen to collect sale amounts and utilise the proceeds towards their own expenses and commission is most undesirable as it opens up a way for fraud.

The sales moneys, if collected by the travellers, should be remitted by them intact to the office, and cheques should be issued by the latter in respect of their salaries, expenses and commission on receipt of their periodical statements. The travelling salesmen should be allowed to issue Temporary Receipts on collection, whereas Confirmatory Acknowledgments should be sent by the Office. As a precautionary measure, there should be a clear notification on the Temporary Receipt that a Confirmatory Receipt must follow from the Office within a stated period, and, if not so received, the fact should be intimated direct to the Office by the customer without fail. In case of accounts in respect of which collection is overdue, the Office should send reminders direct to the customers concerned. As a final check, periodical statement of account would be issued to each debtor requesting him to notify the Office if the balance owing by him as indicated therein is not correct.

CASH PAYMENTS

(1) All payments beyond a certain amount, say Rs. 20/-, should be made by cheques, and payments of sums less than that be made out of Petty Cash.

(2) A proper acknowledgment should be obtained in support of every payment, and each such voucher should bear a consecutive number.

(3) All such vouchers should be pasted in a separate file in a serial order so as to facilitate verification.

(4) The number of each voucher must appear against the respective entry for payment in the Cash Book in a special column provided for the purpose.

(5) No cheque should be drawn for payment to a creditor for trade supplies, unless the periodical statement received from him is verified with the Ledger Account and initialled as correct by the one who did the checking.

(6) Each such statement should then be passed for payment by one of the partners, the managing director or someone in authority.

(7) The Cash Book should be verified with the Bank Pass Book and a Reconciliation Statement prepared and entered in a book provided for the purpose at least once a month. This can preferably be done by some one other than the cashier.

(8) The Office Cash Balance, if any, should be counted at irregular intervals and verified with the Cash Book by some responsible official.

(9) All cheques should be signed by one of the partners or by some authorised person. The person signing the cheques should also initial their corresponding counterfoils.

(10) In large undertakings, it is often highly desirable to have cheques countersigned. But the counter-signature should not be done in a perfunctory manner. It would be a flagrant disregard of responsibility, if one of the parties signs blank cheques in advance as is often done, for the sake of convenience.

PETTY CASH TRANSACTIONS

(1) All petty disbursements under, say Rs. 20/-, should be made by the petty cashier.

(2) The Petty Cash Book should be maintained on the Imprest System with analytical columns for the usual heads of expenditure. The amount of petty cash to be kept in the office should be limited to the reasonable requirements of the business for a period not exceeding a month.

(3) Every payment must be evidenced by a proper voucher. In cases where acknowledgments for payments cannot be obtained, a list should be made out of such items at the end of each day and presented to some authorised person for initial.

(4) The Petty Cash Vouchers should be numbered consecutively and must be pasted in a serial order, in a separate file. The number of each voucher must also be shown against the entry in the Petty Cash Book for facility of checking and reference.

(5) The Petty Cash Book should be examined with the vouchers by the cashier at least once a month, before he issues the imprest cheque for the total amount of disbursements.

(6) The petty cashier should not be allowed on any account to receive any sum, however small, other than the imprest cheques he receives from the cashier.

THE BUYING DEPARTMENT

The main functions of the Buying Department are to see:—

(1) That all purchases are based on properly authorised requisitions, stating the purpose for which the goods are required;

(2) That all goods or materials requisitioned are duly ordered out from the right suppliers;

(3) That deliveries of all such goods are received within the stipulated period ; and

(4) That the goods are bought in the cheapest market and on most favourable terms of payment.

EFFECTIVE CONTROL OVER PURCHASES

The following regulations may be suggested for an effective control over purchase of goods and their proper record:—

(1) Only certain responsible officials should be authorised to sanction orders for the purchase of goods.

(2) With the exception of small sundry purchases which are urgently required, no goods should be obtained without a written order being issued and signed by the responsible official authorising the same.

(3) The head of each department, branch or section of the business is supplied with a Requisition Book to be filled in by him whenever he wishes any goods to be ordered. The Requisition Note would indicate, (1) the department requisitioning the goods, (2) the description of the goods, (3) whether they are required for stock or sale, (4) the price within which the supplies should be obtained, and (5) the time within which delivery is required.

(4) All such Requisition Notes are submitted to the head of the Buying Department, whose duty is to determine when, in what quantity and from which supplier the purchase should be made. These Requisition Notes would then be countersigned by the General Manager.

(5) The Requisitions are now passed on to the Purchasing Clerk who writes out the order in a bound Order Book with two carbon copies.

These orders should specify the conditions of delivery, carriage and packing, the place at which and the time within which they are to be delivered, and the terms and date of payment. The suppliers are requested to quote order numbers on all Invoices and correspondence.

(6) One copy of the Order is sent to the suppliers, and the other to the Store-Keeper or the Department requisitioning the goods. The third copy remains in the Buying Office.

(7) Each Requisition Note is numbered consecutively and properly filed. The serial number of the corresponding Outward Order is shown on each Requisition Note, whereas the number of the Requisition Note is indicated on the Outward Order for easy reference.

(8) On each order being acknowledged and the delivery conditions being accepted by the supplier, the Purchasing Clerk advises the Receiving Department or the department which requisitioned the goods as to when the delivery of the same is expected.

(9) Immediately on receipt of an Invoice, it should be examined by the Buying Office with the view of ascertaining whether the general conditions of the order have been complied with, and the price charged is as stipulated.

(10) Should the Invoice be found correct, it would be numbered and sent to the department which received the delivery of the goods, to be certified as to the correctness or otherwise of their quantity and quality. After comparison, the copy of the order should be so marked or ticked as to show that the corresponding Invoice has been received.

It is highly desirable that the supplies be examined or tested as soon as possible after receipt. If there are deficiencies in supplies or defects in them, they should be reported to the office so that the matter may at once be taken up with the suppliers.

Very often, it is desirable that the department receiving the goods should not be informed as to the source of supply or the price paid, and the original Invoice is not sent to the Stores Department but is retained by the office. It is equally preferable that quantities, etc., expected should not be advised to the Store-keeper in advance. The Receiving Department, in this case, should be asked to make out a Goods Received Note or a Goods Received Sheet giving details as to the quantity and quality of goods actually received daily. On receipt of this Note by the office, the items will be checked off in the corresponding Invoices.

This method of check has found much favour with large establishments as it ensures an independent count and inspection of the goods by those receiving them rather than depending on their honesty and carefulness in checking off the items from the original Invoices. If the Invoices are sent to those receiving the goods for the purpose of the quantity and quality

being certified by them, the chances are that they might be returned to the office as correct, without the necessary count or examination being made.

(11) The prices charged in the Invoice must necessarily be checked by someone in authority who should initial the same. The clerk checking the extensions should also put his initials on the Invoice indicating the checking done by him.

(12) Each Invoice having thus been checked and certified as to the goods having been received as per the order and in good condition, as to the prices charged and the calculations and extensions being correct, will now be passed on to the counting-house for being entered in the Purchase Book.

(13) Each Invoice is given a consecutive number and the same is indicated against its corresponding entry in the Purchases Book for facility of reference and verification.

(14) No Invoice should be passed for payment except for goods properly ordered and received in good condition and correct to specification.

(15) The Requisition Notes which created the orders, the Purchase Orders, the Purchase Invoices and the Goods Received Notes all bear reference to each other and are properly filed, thus considerably facilitating ready access to any of these forms for detailed information, whenever desired.

PURCHASE ROUTINE IN A FACTORY

It is equally important to obtain a strict control over the purchase and use of materials and the recording of the receipt and issue of the articles, to ensure efficient and economical working of a manufacturing concern. The Buying Office, the Contract Department who handle the orders received, and the Stores Department must all work in perfect harmony. On receipt of each order, the Contract Department should prepare a complete specification of the materials required, and a copy of the same be issued to the chief store-keeper. The store-keeper would then indicate the items available in the stores, and the items not available and which would require to be purchased. The Contract Department would make out Purchase Requisitions for articles to be bought and issue them to the Buying Office. At the same time, the Planning Section would be informed about the items of manufactured stock, if any, required. The store-keeper is also supplied with a Stores Requisition Book which he has to fill in and submit whenever his stock of any item of stores gets low and needs replenishing.

All Invoices, upon receipt, should go first to the accounting department to be checked with the purchase orders and then to be numbered. The quantity actually received and the quality should be checked and certified by the Receiving Department. The prices charged should be checked by some responsible person. In the event of there being any difference in the price, quantity or quality of the goods, the accounts department would at

once be informed of the same, and a debit note would be made out for the amount claimed.

CONTROL OF STORES

Thefts of merchandise or stores by those charged with their custody are common, especially in large industrial concerns, and professional auditors are often called upon to devise systems of accounting and internal control as will reduce such thefts to a minimum. While devising such a system, therefore, the main objects to be attained by the Stores Department would be to maintain the minimum stock prescribed, to control waste, to render pilfering more difficult and to provide records of quantities received and quantities issued. The fact that he is as much responsible for the articles in his charge, as the cashier is for the cash, should be thoroughly impressed on the store-keeper.

The duties of those in charge of the Stores would be:—

(1) To receive and check all goods and materials against original purchase orders.

(2) To store the materials properly.

(3) To deliver the same to the factory departments on receipt of proper Requisition Notes from responsible persons; and

(4) To maintain quantity records of stores received and stores issued.

For an effective control over stores and stock, the following rules are highly essential and should be rigidly enforced:—

(1) Every item of stores should be given a fixed reference number and should have a definite place assigned to it.

(2) There should be a proper classification and grouping of similar articles, a proper arrangement of racks and bins, and the whole department must present an orderly appearance.

(3) The stores of heavy and cumbersome articles should be located as near as is conveniently possible to the shops or departments in which the articles are mostly used, the idea being to reduce labour in handling to a minimum.

(4) The store room should be so located that everyone while entering or leaving it should pass by some responsible official.

(5) Not a single article should be issued without the issuer receiving a formal requisition for them from some authorised person.

(6) Only certain authorised persons should be allowed to remove materials or articles from the store room.

(7) In establishments where large number of work-people and others pass through the gate, the watchman or gatekeeper should have instructions not to allow any raw material or manufactured goods to be taken outside the factory either by employees, or in carts or other vehicles, without the necessary permit from the store-keeper.

(8) Such permits or passes out should be entered by the gatekeeper in a Gate Book which should also contain records of goods received from vendors, or returned by customers. Such Gate Book should be periodically checked in the office.

(9) The Stores Ledgers which can most advantageously be kept on the loose-leaf method, should be under a separate control from the actual stores, as they are for the purpose of a check upon the Store-keeper.

(10) As a further check on the quantities of stores handled, a card should be attached to each lot of stores and hung outside each bin or rack, and the quantities received or taken out recorded thereon. As these Bin Cards would be written up by those who handle the stores, whereas the Stores Ledgers would be written up from the Stores Received Sheets and the Stores Issued Book or Stores Issue Requisitions, and maintained by persons independent of the Stores Office, a very useful and independent check would be secured on the receipts and issue of stores.

(11) At irregular intervals, a responsible official must actually count articles from some racks or bins taken at random and compare the quantities thus shown with the balances as indicated by the Stores Ledger or the Bin Cards. Any discrepancies or leakage thus discovered should be reported at once.

(12) The Planning Section should fix the minimum and maximum quantities for each class of materials and stores to be stocked, and the store-keeper should see that all the items in his charge are maintained within their proper levels. This is very important in view of the fact that whereas on the one hand it would be sheer folly to lock up capital in stocking stores in much larger quantities than necessary, it would on the other hand be poor economy to run short of stock of any particular item when most needed and thus impede the progress of work for want of necessary material.

RECORD OF MATERIALS AND STORES RECEIVED

In view of the purchase of Raw Materials and Stores running into enormous sums in a large manufacturing concern, the following further details regarding their proper record and control will not be out of place.

On arrival of the goods at the factory, the receipts should be accurately recorded by the store-keeper. As already pointed out, in order to secure a good check on the actual receipt of stores, it is desirable that the store-keeper should not be advised in advance by being sent the Invoices. The checking of the Invoices should be left to the Buying Office and the Accounts Department.

All materials and stores received from day to day will be recorded by the store-keeper on Goods Received Sheets which are numbered serially and are prepared in triplicate. One copy will be retained by the store-keeper,

one will be forwarded to the stores accountant and one by way of advice to the Buying Department to enable them to compare how the deliveries are being made to time. Loose sheets are preferable to bound books on account of the greater ease with which entries can be made and circulated to the departments concerned. Such Goods Received Sheets or Notes should be supplied to each department where delivery is taken of raw materials, stores or other goods purchased so that these may be written out and the necessary departments may be advised on the arrival.

GOODS RECEIVED SHEETS must contain the following details: (1) Date of Receipt, Supplier's Name, Purchase Order No., by Railway or Delivery, Carriage Paid or To-Pay, No. of Packages, Description of Material, Quantity or Net Weight received, Quality, Bin Card No., Stores Ledger Folio or Stores Card No., Invoice No. and Date. The last two columns will be filled in by the Stores Accountant. The store-keeper will check the quantity of goods received and certify to that effect. The quality will be examined by the Inspection Staff, and if the goods are defective in quality, the Purchase Department will be informed of the same and the latter will take the matter up with the suppliers concerned.

The Buying Office will check the details from the Goods Received Sheets against the corresponding Invoices and will insert the number of the job, if the goods are required specially for any job, and ascertain if the price charged is correct, and will then forward the Sheets after inserting the prices to the Stores Accountant for entry of debits to the Cost Accounts concerned. An extra copy of Goods Received Sheets provided with money column may be used to replace the entry of separate invoices in the Purchase Analysis in order to arrive at the record of Total Value of Materials and Stores Purchased to serve as a check on the total Invoices entered in the Purchase Journal for the same period.

These Goods Received Notes or Sheets are then entered by the Stores Accountant in the Stores Record Cards, the receipts of stores being debited to their respective accounts.

Experience has shown that it is desirable to eliminate from the Stores Department all clerical work necessarily involved in the accounting of materials and stores. This work is now transferred to a Stores Accountant in the Cost Department who is free from handling of goods and is engaged independently on clerical work. Being thus detached from the Stores Department, he is apt to make cleaner and more accurate records in less time. The further advantage of having the stock transactions recorded apart from the stock material department is to secure more efficient checking of the incomings and outgoings of the stores.

BIN CARDS

The clerical duties which must necessarily be done in the Stock and Stores Departments would be restricted to writing up of purchase requisitions,

completing foremen's requisitions, entering up Goods Received Sheets and filling in the Bin Cards. On receipt of the materials in stores, the store-keeper will place them in the bin or rack provided for it, and will then enter on the relative Bin Card the quantity received, and adjust the balance column. The Bin Card is hung on a hook outside each bin, rack, division or receptacle, as this card must be available for entry whenever goods are placed in or taken out of the bin. The maximum and minimum stock of each item necessarily required is stated clearly on the record, and as a result of the quantity record of all inward and outward transactions appertaining to each item of stores on these Bin Cards, the stock is easily and accurately controlled by the Stock Department. The Stock Bin Card balances signify the actual stock in hand of each particular item from day to day, and these balances must agree with the balances as indicated by the corresponding Stores Record Cards maintained by the Stores Accountant, who has nothing to do with the handling of the goods. When the balance on any card shows the stock to be nearing the minimum quantity, a purchase requisition should be issued by the store-keeper.

STOCK OR STORES RECORD CARDS

In a business where the number of individual items of stores is small, a convenient method of recording the receipts and issues of quantities would be by means of a Stores Ledger; where, however, there is a large number of items and there is constant incoming and outgoing of stores and materials, a Card system of record would be found more suitable. A full description of the item of store or material is inserted at the head of each card together with the number of the bin or rack in which the material is stored.

A separate Card is allotted to each item of Stores and each such card will contain information as under:—

- (1) Quantity and value of stores received.
- (2) Quantity and value of goods requisitioned and issued.
- (3) Balance quantity on hand.

DUTIES OF THE STORES ACCOUNTANT

The duties of the Stores Accountant engaged upon the writing up of Stores Record Cards will thus chiefly consist of:—

- (1) Posting particulars of all goods received in stores as shown by the Goods Received Sheets into the Stock Record Cards.
- (2) Posting particulars of all goods issued as represented by the Stores Issue Requisitions.
- (3) Checking and comparing the Stores Records with the actual quantities in stock and the Bin Cards at frequent intervals.

There will thus be two distinct records of quantities:—

(1) The STORES RECORD CARDS which are maintained by the Stores Accountant attached to the Cost Department.

(2) The BIN CARDS written up in the Stores Department by way of record of all the items of stores handled.

The detailed record of Stores received and issued out by means of Stores Record Cards and the Stock Bin Cards may entail considerable clerical labour, but is indispensable in an extensive manufacturing business as it will undoubtedly result in enormous benefits being secured by way of safeguarding against pilfering, controlling waste and providing means of taking an inventory without closing down the works.

RECORD OF MATERIALS AND STORES ISSUED

In well-organised Stores, the store-keeper has strict instructions not to issue any materials, unless a Stores Issue Requisition in writing signed by a responsible works official is presented to him. Such Requisition Note must indicate the quantity and nature of materials or stores and the works order number of the department for which the goods are required. The store-keeper on receipt of such requisition issues the materials and receives the signature of the person receiving the material. He then enters on the Bin Card, the date, requisition number and the quantity issued, and adjusts the Balance Column. The Stores Requisition is then initialled by him and passed on to the Cost Department for entry by the Stores Accountant. The entry showing the issue of quantity will then be made in the Stores Record Card bearing the same Bin Number. The Stores Accountant then inserts on the Stores Issue Requisition the price of the material issued which he ascertains from the Stores Card. The object of inserting the price is to enable the issue of materials to be charged to the different jobs or departments at the actual price paid.

In a properly organized business, the Stores Requisition or Issue Notes for stores required for different purposes are printed on paper of different colours so as to facilitate allocation. Thus, there are requisitions for:—

(1) PRODUCTION ORDERS, for supplies of productive material for (a) Customers' Orders, or for (b) Standard Parts required for stock purposes.

(3) PLANT MAINTENANCE SERVICE, for supplies of Material for plant repairs and renewals chargeable to Works Expenses.

(3) TOOLS OR PATTERNS SERVICE, for Materials required for production of Tools or Patterns either for special jobs or for general use.

(4) CONSUMABLE STORES, for supplies of non-productive material such as Belting, Oils, Lubricants, Cotton Waste, etc., chargeable to Works Expenses.

(5) **MATERIAL FOR SPOILT WORK**, for productive material required to replace the original quantity issued, but chargeable to "Defective Work Account" and not to the job in respect of which it is issued.

The use of different coloured forms will not only facilitate the work in the Cost Department, but upon their presentation to the store-keeper, the latter can see at a glance what type of material is required.

MATERIALS OR STORES RETURNED FROM JOBS

Materials or Stores supplies issued for jobs or departmental use and not required and returned to the store-keeper must be properly recorded so that they may be duly entered up in the stores records and their values may be credited to the accounts of the jobs or departments concerned, by the Cost Department. For this purpose, **MATERIALS RETURNED NOTES** are written out which are similar to foreman's requisitions but printed in red and bear serial numbers. They are made out in triplicate, two copies being sent to the store-keeper along with the returned material. One of these is returned to the foreman with the store-keeper's acknowledgment. The copy retained by the store-keeper is entered by him on the Bin Cards and then passed on to the Stores Accountant to be entered by him in the Stores Cards. It will then be priced and dealt with by the Cost Department, the Account of the Job or Department concerned being given credit in respect thereof.

MATERIALS TRANSFERRED FROM ONE JOB TO ANOTHER

Instances occur of materials issued originally to one job being transferred to another job or order without passing through the stores. In such a case, the foreman transferring such material will make out a **MATERIALS TRANSFER NOTE** indicating the job number to which the materials are transferred. These Notes are also numbered serially and are made out in triplicate, two copies being sent to the receiving foreman. One of these will be returned to the issuing foreman by way of an acknowledgment from the receiving foreman, and this will then be sent to the Cost Department for the purpose of a credit being given to the Job Account issuing such material and a debit to the one receiving the same. As a transaction of this description will not in any way affect the Stores Department, no record thereof is necessary either in the Bin Cards or the Stores Cards.

CONTINUOUS STOCK-TAKING

In large manufacturing concerns, the usual method of stock-taking at the end of each financial year is often dispensed with, and in place thereof is adopted a method of stores inspection throughout the year, by which not only is a constant check maintained on the whole of the stock, but waste or leakage of material and stores is immediately brought to light and all discrepancies are soon set right. Under this method, the contents of several bins or racks are counted or weighed, from day to day, and the actual quantities

on hand as ascertained on count are checked with the Bin Cards or Stock Record Cards. Such an inspection, in order to have any real value, should be done by persons independently of those in charge of the stores. All discrepancies detected should be adjusted on the Bin Cards as also on the Stock Record Cards under proper authority and duly initialled. A further check on stores is also secured when the store-keeper finds any item in the stock has fallen below the minimum quantity, when he must necessarily see that the actual balance on hand tallies with the quantity as shown by the respective Bin Card before re-ordering. A continuous and efficient check is thus maintained on the enormous quantities of material and stores dealt in, which would not be possible under the ordinary system of stock-taking at periodical intervals.

FACTORY WAGES

In the case of manufacturing concerns, the preparation of the Wages Sheets as also the subsequent payment of Wages call for a most carefully planned system of internal check, as a large number of defalcations have their origin in the payment of wages.

The fundamental points to be observed while devising any system of internal check in this connection should be:

- (1) That the engagements and rates of pay shall be duly authorised by the management;
- (2) That there should be a proper record as to the employment of each workman, his trade, department, date of starting and leaving and any intermediate changes;
- (3) That accurate records shall be kept of employees' attendance from day to day and the actual time spent on each job so as to constitute the basis for ascertainment of wages;
- (4) Where payment is made by result as in piece-work and premium systems, such payment shall be accurately computed according to the viewer's certificates and the authorised piece-work;
- (5) That all overtime and working at exceptional hours shall be authorised;
- (6) That wages having been computed accurately shall be made up accurately and paid out to the correct persons;
- (7) That as many clerks and officials as possible should be engaged in the preparation and checking of the Wages Sheets and the payment of wages so as to prevent collusion.

RECORD OF WAGES

It is essential for the record of time spent in the works by the workmen to be correctly obtained, and for this purpose, the time-keeper is usually provided with either a time board on which each workman can hang a

brass check bearing his number, or a mechanical clock-work drive in which each man punches his time card every time he enters or leaves the factory. When such recording is in progress, the presence of the time-keeper is essential in order to see that no workman hangs the check number or registers the time of others who are late or absent.

TIME-WORKERS.—Each workman is also provided with a Time Card on which he would record the time put in by him from day to day and indicate the job on which he was engaged or the department in which he worked, each such entry being initialled by his foreman.

PIECE-WORKERS.—When the workmen are employed on piece-work, they should, when starting on it, be supplied with a Piece-Work Return Form or a Job Card, on which is specified the job number, the nature of the work, and the rate at which it is undertaken. On completion of the work, the piece-worker hands over his sheet to a viewer who initials the Form or Card after inspecting the work.

COMPILATION OF WAGES SHEETS

The following steps should then be taken at the end of each week or month, for the compilation of the Pay Roll and the subsequent payment of wages:—

(1) The total time provided by the Time-keeper's Book from the time-board where metal discs are in use, or that punched on the time-cards by the mechanical recorder, is checked off and agreed with the time as indicated by the corresponding Job Cards or Piece-work Cards written up by the workmen themselves and signed by their respective foremen or with the foremen's summaries.

(2) In case of a large factory, the Pay Roll should consist of loose sheets so that the work may be capable of being distributed amongst the Wages Office Staff and can thus be performed with greater despatch than would be possible if the Pay Roll is in the form of a book. Further, it would be desirable to make up the wages of each Department separately as this would help considerably towards the ascertainment and checking of departmental labour cost.

(3) The Pay Roll should comprise details as to each workman's number, time worked, description of work, rate, amount of wages, bonus, total amount payable, deductions (if any) and the net amount payable.

(4) A set of clerks should be engaged to enter up from the Job Cards and Piece-work Cards the numbers of the workmen, the number of hours worked by each of them, the rates of pay and the particulars of any deductions to be made. These should then be checked by some other clerks.

(5) The total amount of wages due to each workman would now be worked out and the Wages Sheets cast by another set of clerks.

(6) These Sheets should then be checked by some responsible clerks as to the rates, calculations, and casts.

(7) The Job Cards of time-workers and the Piece-work Cards would also be sent to the Costing Department in order that the wages chargeable to each job, process or department may be ascertained, and for this purpose, the whole of the wages for the week or the month would be analysed and duly classified.

(8) The total amount of wages for each week or month as ascertained by the Counting House must necessarily tally with the total of the Wages Analysis Sheets for the corresponding week or month as prepared by the Costing Department.

(9) Every person concerned in the preparation of the Wages Sheets should put his initials thereon indicating the nature of the work done by him, and these should finally be countersigned as a whole by the Works Manager or some other responsible official.

(10) The total wages of the week or the month in question having been made up and checked, one cheque should be drawn for the whole amount. The payment of the wages should be made by the cashier who should have no hand in the preparation of the Wages Sheets, as described above.

(11) The payment should be made to the men of each department in the presence of their respective foremen, who would also be made to initial the Wages Sheets.

(12) The Works Manager should also be present at the time of payment and should sign the total wages of the week or the month as an indication that such wages were duly authorised.

It will be seen from the foregoing, that if the above rules are rigidly followed in the compilation of the Wages Sheets and payment of the wages, there would hardly be any chance for clerical mistakes to creep in and remain undetected; whilst the number of persons through whose hands the returns pass, each acting as a check on the others, should prevent peculation and fraud.

PIECE-WORK REGISTER

In factories where a substantial portion of the work is obtained on piece-work basis, the maintenance of a Piece-Work Register would prove to be of considerable advantage. Such a Register would be written up from the Piece-Work Returns or Cards and will serve to afford most valuable information as to whether any particular type of piece-work is favourable or otherwise to the employers and would help considerably towards the fixing up of piece-work rates. Besides, from the data thus obtained, most useful comparisons can be drawn between the result of piece-work rates and the day-rates obtaining in the same departments or sections of the factory.

OVER-TIME SLIPS

All over-time to be put in by workmen should be duly sanctioned in advance on over-time slips by some one in authority, usually the foreman in charge, and these slips after being initialled by him should be passed on to the time-keeper to be forwarded to the Wages Office. Such slips should specify the workman's No., the date, the over-time put in and also indicate the Job or Department or Process on which such over-time was worked.

PASS-OUT SLIPS

Great care should be taken to ensure that once the workmen have entered the factory, they cannot leave it before the scheduled time without a written authority. Such authority would take the shape of a Pass-Out Slip which must bear the foreman's initials and which should be handed over to the Gate-keeper. The slips should indicate whether the worker is going out on his own or on the firm's account. A carbon copy of this slip is simultaneously sent to the Wages Office, and if the worker happens to go out on his own account, the Gate-keeper should initial it as an indication of the man having been timed out. At the time of making up the wages, the Pass-Out Slips as initialled by the Gate-keeper should be checked with their corresponding copies received by the Wages Office to ensure proper deduction of the timings of the men having gone out before time.

ADVANCES TO WORKMEN

The common practice for workmen to be paid advances against wages should be discouraged, as far as possible, as it complicates the making up and paying of wages. Besides, innumerable instances occur of workmen leaving their jobs after receiving advances and before earning these in wages, and this would entail a loss to the concern. If, however, advances are unavoidable, the method to be employed would be for such payments to be made through the petty cash, and on the petty cashier presenting a statement of such advances to the Wages Clerk, the latter to repay the amount from the workmen's wages.

SALES CONTROL

The following procedure should be adopted in regard to the Sales from the receipt of the customer's order to the entry in the Sales Book. The main object to be attained in this connection would be to see that all orders are executed promptly and properly, that all goods are checked with their respective orders before being packed, and that no goods leave the premises without their being properly charged to the customer concerned.

(1) Immediately on receipt of an order, it should be numbered and entered in Register of Orders Received, where full details would be given as to the date of the order, and the customer's name. On the order being executed, the date of the invoice and the invoice number would also be entered therein.

(2) Either the original order or a copy thereof would then be handed over to the Despatch Department with necessary particulars and instructions as to packing, mode of transport, etc.

(3) On the goods ordered being got ready for delivery, they should be checked off with the original order before being packed.

(4) As soon as the order is executed by the despatch of goods, the original order or the copy thereof will be returned by the Despatch Department to the Counting House for the purpose of an outward Invoice being made out in the name of the customer.

(5) It would be the duty of some responsible person to see that the rates charged to the customer are proper.

(6) After the Outward Invoice is made out with a carbon duplicate copy, the particulars stated therein as to the quantity and quality of goods and the rates charged should be compared with the original order, and the Invoice should be initialled accordingly by the person who did the checking.

(7) The calculations and extensions are then checked by some other clerk who also initials the Invoice to indicate the work done by him.

(8) The Invoice is then passed on to the Invoice clerk who enters it in the Sales Day Book. One copy of the Invoice with perforations is torn off and sent to the customer, whereas the other remains in a bound form in the Outward Invoice Book.

(9) The original orders after being executed are numbered consecutively and properly filed. On each Outward Invoice would be marked its corresponding order number, whereas the number of the Invoice would be marked on the original order.

(10) The gate-keeper should maintain a book called Goods Outwards Book in which should be entered particulars of all goods going out of the premises. The entries in this book should be checked with the Outward Invoices by some responsible person from time to time.

(11) Where a large number of orders are executed each day involving numerous entries in the Day Book, two sets of Sales Day Books are maintained to be used on alternate days, in order that postings into the Customers' Ledgers may be done uninterruptedly without inconveniencing any one.

(12) It must be remembered that a prompt execution of order always impresses the customers most favourably, and great attention should, therefore, be paid to the timely despatch of goods.

(13) All sale contracts should be entered up in a special book, and orders executed against these from time to time should be duly recorded therein.

(14) When sales are effected by travellers, each traveller should be supplied with a triplicate Sale Note Book, in which he would enter particulars of each sale. One copy of this entry would be delivered to the customer,

another would be despatched to the head office for execution of the order and the third would remain in his book for reference.

(15) The various checks and counter-checks as shown above would ensure proper execution of each order and a correct entry being made in respect thereof in the Sales Day Book.

(16) On goods being returned by customers, the particulars thereof should be entered by the Gate Office in a special book called Goods Inwards Book, a carbon copy of which would be sent daily to the Counting House. On such goods being duly checked with the Debit Note received from the customer, a Credit Note in respect of the same would be made out in duplicate.

(17) It would be the duty of some responsible person to check and initial each Credit Note before despatch.

(18) Entries would then be made from these Credit Notes in the Returns Inwards Book. Each Credit Note is numbered consecutively, and the number is indicated against the corresponding entry in the Returns Inwards Book.

SUB-DIVISION OF LEDGERS

In a large business where the transactions are voluminous, several Ledgers will have to be employed to accommodate all the Accounts. No general rule can be laid down as to the proper sub-division of Ledgers, as so much would depend on the requirements of each particular business. In any case, the following arrangement has been found to work satisfactorily:—

(1) There should be a Ledger or Ledgers for the purpose of keeping accounts of customers only;

(2) A Ledger or Ledgers for the record of Creditors' Accounts, i.e., Accounts of Suppliers of Goods;

(3) An impersonal or General Ledger for all accounts other than those of Debtors and Creditors; and

(4) A Private Ledger to accommodate all accounts of a private nature, such as Capital Accounts, Drawings Accounts, Loan Accounts, Stock Accounts, etc., in regard to which it is not desirable for every member of the staff to have information. Such a Ledger would, of course, be kept and written up by one of the partners or a responsible official, and the record made therein would be treated as highly confidential.

Each Ledger-keeper should be held responsible to keep the Ledgers under his charge posted up to date, and balanced at periodical intervals.

In order to facilitate location of clerical errors and to help towards the agreement of the books soon after the close of the financial period, each Ledger should be made self-balancing.

The postings from the Books of Original Entry into the Ledgers should be called over at fixed intervals by some clerks independently of the Ledger-keepers.

No one in charge of any Personal Ledger should be allowed to come into contact with the customers or the creditors of the firm, and where practicable, the persons in charge of these Ledgers should be changed about so that no irregularity can remain long undetected.

BAD AND DOUBTFUL DEBTS

All book debts should be carefully watched from time to time to ascertain what balances are becoming overdue, so that prompt measures may be taken for the recovery of the same and thus prevent loss which would otherwise result.

A good plan would be to have a separate Ledger for all doubtful debts wherein all overdue and doubtful accounts should be transferred. The object of so doing is to make sure that all necessary measures are being taken for immediate recovery of these which would not be otherwise possible if such doubtful debts were allowed to get mixed up with the other good and recoverable debts.

No account should be written off as a Bad Debt without the proper sanction of some person in authority whose initials should be obtained against the Journal entry writing off the debts.

Similarly, no balance on a customer's account should be written off as an allowance or extra discount unless the same is properly authorised.

STOCK-TAKING

For the ascertainment of proper stock on hand at the close of each financial period, it is necessary that it should be taken immediately after the close of the last day of the trading period.

The work of Stock-taking should be entrusted to such assistants who can be relied upon to carry out their duties faithfully. In order to expedite the process of Stock-taking, each section of the stock should be apportioned to a set of two clerks, one to call out the quantities and description of the goods, and the other to enter these in the Stock Sheets.

The pricing should be done by one of the partners or some responsible official, after which the sheets would be handed over to another clerk for extensions and casts.

The whole of the Stock Sheets should then be checked as to prices, extensions and casts by some responsible clerk.

The Stock Sheets should be initialled by each person for the work done by him, and those would then be finally certified as correct as to take and pricing by one of the partners or some responsible official.

CONTROL OF DEPARTMENTAL AND BRANCH ACCOUNTS

Where a business is divided into several departments or branches, the system of accounting should be so shaped as would enable the proprietors to know at any time not only how the business as a whole is progressing, but also as to which department or branch is making money and which, if any, is working at a loss. Any good system in this connection should aim at a proper method of controlling the transactions of the several departments or branches and also for due incorporation of these transactions in the main books at periodical intervals.

Where the Branches take the shape of shops or depots for the sale of Head Office products, each Branch should be asked to remit its receipts intact to the Head Office at regular intervals, or bank the same daily in an account opened in the name of the Head Office. Branch expenses, in this case, should be met by the Head Office by cheques, and to meet small disbursements, a petty cash balance should be kept at each Branch on the Imprest System. Each Branch need maintain only a Cash Book, an Analytical Petty Cash Book, a Day Book and a Customers' Ledger. A Stock Book would also be found very useful.

In order to keep the Head Office well informed as to the transactions of each Branch, full details of business done by each Branch should be sent to the Head Office daily, weekly or at convenient intervals. Such information can well be conveyed by means of the following statements:—

(a) A RECEIPTS AND PAYMENTS ACCOUNT, showing the opening balance of cash on hand, if any, cash receipts and payments during the period, and the closing balance of cash on hand, if any.

(b) A STATEMENT OF TRADE DEBTORS, showing the opening balance, total credit sales during the period, total cash and bills received, discount, allowances and returns during the period, and the closing balance.

(c) A STATEMENT OF TRADE CREDITORS, showing the opening balance, total credit purchases during the period, total cash and bills paid, discounts, allowances and returns during the period, and the closing balance. This statement would be necessary only where the Branch does any local buying.

(d) A STATEMENT OF STOCK on hand in a summarised form.

Where the goods supplied by the Head Office to the Branches are marked at Selling Price, the system of book-keeping employed should be such as would readily admit of the various adjusting entries being passed in the Head Office books at each balancing time, with a view to determine the actual profit or loss made by each Branch. The balance of unsold stock at the Branches should be taken at cost by the Head Office for Balance Sheet purposes.

Where the Branches trade independently of the Head Office, each Branch will have to maintain a complete set of books so as to be able to compile therefrom its own Profit and Loss Account and Balance Sheet, and the Head Office will have to incorporate the Trial Balance of each Branch in its own books at the close of each financial period with the object of arriving at the total working results of the business as a whole.

Where the Branch is located in a foreign country, its books would naturally be written up in the foreign currency, and the question that would then arise would be as to how the figures of the Branch Trial Balance should be converted into the Head Office currency for the purpose of their incorporation in the Head Office books.

Where the rate of exchange between the currencies of the Head Office and the Branch is fairly stable, slight fluctuations are ignored, and a fixed rate of exchange is used in converting all the items of the Foreign Branch Trial Balance.

Where, however, the rate of exchange is subject to constant fluctuations, the following rules must be observed in converting the various items of the Foreign Branch Trial Balance into the currency of the Head Office, at the end of each financial period:—

1. Fixed Assets and Liabilities must be converted at the rate of exchange ruling on the day on which they were acquired or incurred.
2. Floating Assets and Liabilities must be converted at the rate of exchange ruling on the date of balancing the books.
3. Revenue items must be converted at an average rate of exchange ruling in course of the period under review.
4. The Head Office Account must be converted at the same figure at which the particular Branch Account stands in the Head Office Books.

Where the fluctuations in exchange between the currencies of the Head Office and the Branch are incessant and violent, a still better method for the Head Office is to convert the revenue transactions of the Branch, at the end of each MONTH instead of at the end of the financial year, with the average rate of exchange ruling during each particular month.

COST ACCOUNTS

For a correct ascertainment of the actual cost of the various articles in their several stages of production, a sound and perfect system of Cost accounting is indispensable to a manufacturer.

The main object of Cost Accounts irrespective of the branch of industry to which they are applied should always be to express faithfully and accurately the actual cost, and the most important characteristic of any efficient costing system should be that the incidence of material, labour and direct and indirect expense falls where it should fall, and that no one department,

process or product is made to bear charges and expenses which should have been more equitably charged to another. To install a system of cost finding that would be of the highest value to the manufacturer, a thorough technical knowledge of the product as well as complete commercial and organising ability are necessary. It is impossible to make the working of any business fit into a ready-made costing system. The system must be adapted to suit the requirements of the business; but, while introducing a system in any business, it is desirable to proceed with caution at the outset and to extend the system according to the necessity.

Whichever method of cost finding is employed, it is of the first importance that the cost accounts should contain records of all the amounts consumed by the concern during any given period, whether such consumption is represented by cash, materials, or consumable obligations incurred. The total revenue expenditure of a manufacturing concern during any one financial period would then represent the cost of the products (finished or partly-finished) manufactured during the same period. The system adopted must result in this total expenditure being distributed over the whole of the work executed (whether completed or in progress) by a process of most minute and critical analysis of each distinct head of expenditure. The result will then be the true cost of each article or product.

ESSENTIALS OF A SOUND SYSTEM OF COST ACCOUNTING

To secure the fullest benefits from any good system of cost accounting, the following conditions are absolutely essential, and cannot be too strongly emphasised:—

(1) For the ascertainment of accurate costs, **DEPARTMENTALISATION OF WORKS** is absolutely essential, and the more perfectly this is done, the more effective will be the supervision and control, far simpler will be the process of allocation and distribution of expense and more reliable will be the costs. The production work of any factory is always supported by a variety of auxiliary services which are all so very necessary for the fulfilment of the functions of a factory and which are so closely interlinked with the main business of production. Just as it is difficult to imagine a fighting unit without its transport, medical, commissariat and other services, it is equally hard to conceive of the Productive Department of a large factory without its Building, Power, Plant, Laboratory, Tools, Stores, Supervision, Administration and other services. Before attempting to install a costing system, it is essential, therefore, to split up "Manufacturing" and "Service" into departmental forms. The "Manufacturing" activity may then be dissected into as many Departments or Divisions as may be determined by the nature of the processes and the articles manufactured, and the "Service" may be divided into the different types of functions rendered.

(2) If Cost Accounts are to serve any real purpose and to warn and guide those in management, the record should be **ACCURATE IN EVERY DETAIL**.

as any laxity in this respect will tend to give wrong and misleading results; hence, all persons responsible for these records should be impressed with the fact that correctness is as important as in the recording of financial transactions.

(3) **PROMPT COST INFORMATION** is another factor in securing efficiency and is found to be of considerable value for the purpose of preparing estimates for repeat jobs, even under different market conditions, or when a special order or job is worked and the cost is desired immediately on completion of work. The cost of manufacturing material issued out to the various departments or jobs should be promptly reported and allocated. For this purpose, the internal manufacturing and stores departments will have to be instructed to complete their monthly records of all supplies of stores and raw material issued for manufacturing, within a few days of the end of each month. Similarly, the labour and oncost abstracts for the period will have to be promptly completed. Strict instructions should be issued whereby the necessary returns come regularly to the costing department regarding all the cost elements, for entry promptly and accurately to the various Cost Accounts, in a systematic manner.

(4) Cost records should act as a guide for future transactions, and **STATISTICAL DATA** of manufacturing cost and of expense fluctuations must be maintained for the correct guidance and control of every department of the factory, and to serve as a guide for future estimates, quotations and for fixing prices.

(5) All **INSTRUCTIONS AND ORDERS** should be committed to writing, and specially drafted schedules for accounts and printed forms should be used to suit the circumstances in each case.

(6) The **COST OF RUNNING THE SYSTEM** should be kept within reasonable limits and should not be allowed to outweigh the advantages and economies it will effect. The important point to bear in mind, in every case, is that the system should not be unnecessarily elaborate and that the rules must be workable as well as equitable. They must be simple, convenient and also a little pliant, that is, capable of re-adjustment as and when required.

(7) Greatest possible care should be taken in adjusting the **ALLOCATIONS AND DISTRIBUTION OF FACTORY EXPENSES** over the products, and the motive that must always be kept in mind is that each product is made to bear as nearly as possible its fair share.

(8) The **METHOD OF PRESENTATION OF COST** results is also very important. In order to secure best information, there must be a periodical tabulation of results, i.e. comparisons of actual cost of jobs with their corresponding estimates, and comparisons of the cost of similar jobs with one another. These should always be supplemented by periodical reports from the works manager explaining any extraordinary fluctuations.

(9) The whole system should be so arranged as to provide means of controlling in detail and in total all expenditure incurred in connection with production and administration, and form basis of RECONCILING THE COST RESULTS WITH those reflected by the FINANCIAL RECORDS.

ADVANTAGES OF COST ACCOUNTS

The advantages of Cost Accounts may be summarised as under:—

- (1) They help to determine the true cost of each article, process or contract.
- (2) They enable true comparisons to be made of the different classes and quantities of materials used, also of the various methods of manufacture, and give reliable data for the determination of profitable Cost Estimates.
- (3) They conduce towards operative efficiency of the finished manufacture.
- (4) They help towards the prompt preparation of Cost Estimates and fixing of Selling Prices in accordance with any altered market conditions.
- (5) They serve as a means to reducing cost by improving organization and effecting economies in methods of equipment, or by obtaining increased output.
- (6) They act as a means to control and check on the employees by detecting leakages or waste of material, both intentional and accidental, and losses by way of remunerative expense.

SERVICE-DEPARTMENTS ESSENTIAL FOR THE EFFICIENT LAY-OUT OF A FACTORY

In addition to the sections actually engaged upon production work, the lay-out of a factory necessarily demands the departmental organization on following lines to ensure increased efficiency in handling the work.

- (1) ESTIMATING DEPARTMENT for the original handling of inquiries and for preparing estimates in framing tenders, also for maintaining data of how the actual costs compare with the estimates.
- (2) PLANNING DEPARTMENT SUPPORTED BY DRAWING OFFICE for preparing specifications and arranging for requisite materials to provide for the prompt execution of urgent orders.
- (3) BUYING DEPARTMENT to see to the ordering out of materials and stores at favourable terms and in due time.
- (4) LABOUR DEPARTMENT whose duty it would be to engage the right type of men required for the production work at best rates and to maintain a proper historical record of the engagement and discharge of workers.
- (5) STORES DEPARTMENT to handle the incomings and outgoings of stores and to maintain stocks to meet orders on hand.

(6) **TOOLS DEPARTMENT** for manufacturing and repairing the tools used in production and to maintain a correct record of the tools issued out, returned and those in stock.

(7) **INSPECTION DEPARTMENT** to test all products in shape of finished articles and finished parts to see that they conform to specifications. Where the products have to undergo several processes, this Department will have to test the products in their various stages of production.

(8) **SHIPPING DEPARTMENT** for efficient transportation of Finished Orders.

(9) **COSTING DEPARTMENT** to help towards the factory organization and the ascertainment of true costs of the products.

(10) **INTERNAL CHECK DEPARTMENT** to supervise and maintain an efficient check on the proper functioning of the accounts and the costing departments and also to maintain a thorough check on materials, stores and finished products by means of continuous stock-taking.

(11) **THE WELFARE DEPARTMENT** to look after the well-being of the employees during the working hours and to see to their proper housing and recreation.

Others may be added to suit the particular needs of the business.

LOOSE-LEAF AND CARD SYSTEMS

As every day finds additions to the number of firms adopting Loose-leaf and Card Systems in connection with their business records, it has been found necessary to give a short description of what these systems consist of.

LOOSE-LEAF LEDGER

The Loose-Leaf Ledger or the Perpetual Ledger, as it is sometimes called, consists of a substantially made cover or binder, with means provided for expanding the back so as to hold a varying number of leaves. A wide margin is provided on the left-hand side of each leaf with punched holes by means of which the leaves are bound together in the binder. There is a great variety of such binders upon the market, but each and all of them provide a means of locking the Ledger, so that a leaf or account cannot be taken out or put in without the knowledge of the person possessing the key of the binder.

It will thus be clear that although the word loose-leaf unfortunately suggests a state of continuous looseness in the leaves forming the ledger, they are for all practical purposes, as firmly bound together as the leaves of an ordinary bound Ledger.

Any form of Ledger ruling can be utilised. A separate sheet is given to each account and larger accounts can certainly be made to run on several sheets. The accounts can be arranged and re-arranged in any order desired—alphabetical, numerical, or geographical, and Index Sheets can be inserted where desired.

A transfer binder is used with each Ledger, for the purpose of transferring thereto filled leaves as well as all dead or closed accounts, and these transferred accounts are so indexed as to take the same position in the transfer binder as they occupied in the Current Ledger.

It will be seen from the above that the chief characteristic of "Loose-leaf" System is that any and every leaf can be readily taken out and any number of new leaves may be inserted whenever desired, and once the Ledger is securely locked, no leaf can be removed except by tearing or unless the Ledger be unlocked.

CARD LEDGER

The Card Ledger is merely a collection of cards arranged on edges in a tray or series of trays, or in the drawers of a specially made cabinet. Each Card is used for writing up a separate account. Any style of ruling suitable to the business may be used. For convenience of handling, the size of the cards is usually smaller than the pages of an ordinary Ledger. Each card has a hole punched through it, and the trays or drawers are fitted with a metal rod which can be inserted through the cards and automatically locked into position, so that when the Ledger is not in use, the cards cannot be removed by unauthorised persons, and so get lost or misplaced. The cards may be arranged in any suitable way, either alphabetically, numerically or geographically. For the purpose of indexing and sub-indexing, extra cards with projecting tabs of different colours are provided.

Cards as have been filled or which relate to accounts, which have been closed, are transferred to a separate tray or drawer kept for the purpose, and these are indexed in just the same manner as the current drawer of cards.

ADVANTAGES OF LOOSE-LEAF AND CARD LEDGERS

The following are the advantages of Loose-Leaf and Card Ledgers:—

(1) Dead or closed accounts may be removed at any time, thus keeping only active accounts in the Current Ledger.

(2) The Ledger is not burdened with unnecessary blank leaves, as would be the case in the bound books. New leaves are inserted as and when necessary.

(3) The Loose-Leaf Ledgers are continuous and permanent, and it is not necessary to open new Ledgers and Index at the commencement of each balancing period.

(4) The order of arranging accounts in the Ledger when once fixed is not disturbed in spite of frequent insertions of new leaves or removal of dead and closed accounts.

(5) At the time of balancing, the Ledger may be divided between several clerks, so that the work of extracting balances may be expedited. This is not possible in the case of bound Ledgers.

(6) Since dead and old accounts are removed from the Ledger, the work of extracting balances and submitting statements of accounts is much facilitated.

(7) As a transfer binder is used for keeping old records, and as the order of arrangement of accounts is the same as in the Current Ledger, a continuous record of each account is thus obtained for the whole period of its existence. This is not possible in the case of bound Ledgers, and when it is desired to refer to the complete records of an account, several old Ledgers will have to be turned up, wherein the record is distributed in widely separate pages.

There are, however, certain disadvantages of Loose-Leaf or Card Ledgers as follows:---

(a) The leaves or cards may be lost or misplaced unintentionally, in which case it would be necessary to re write the records from the Subsidiary Books.

(b) The leaves or cards may be intentionally destroyed or substituted in order to commit some fraud or conceal some fraud already committed.

PRECAUTIONS AGAINST MISUSE

In order to prevent or minimise these disadvantages, the following precautions may be taken:---

(1) The key of the binder or the card locker should be kept by the principal or some responsible official, so that it may not be possible to remove or insert a leaf or card without the knowledge of the person keeping the key. It is also necessary that the principal or the responsible official should be present at the time of removal or insertion of leaves or cards.

(2) If possible, the name of the business should be printed or water-marked on the face of each leaf or card, so that any substitution by leaves or cards sold on the market may be detected. The printers or manufacturers of the leaves or cards should be instructed not to supply new leaves or cards used by the particular business, excepting on an order signed by one of the principals or a responsible official.

(3) The Stock of unused leaves or cards should be kept under the control of the principal, and complete records of their issue or return should be kept under his supervision.

CARD SYSTEM FOR COSTING PURPOSES

In large undertakings, the Card System of Costing Records is now utilised to a considerable extent in place of bound books, due to the enormous saving in time in the compilation of the necessary data from specially tabulated cards. Specially printed Cards are employed to record the data required, e.g., stores requisitions, time cards, job cards, stock cards, etc., such cards being made to embody the necessary information for costing purposes.

As a result of the Card System being employed in costing, the sub-division of work between members of the staff is greatly facilitated, thus considerably expediting the work. Besides, the costing records are easily capable of being referred to by several members of the staff simultaneously for different purposes, which is not practicable when bound records are utilised. The cards recording each type of information are then duly filed and serve as a ready means of reference.

FILING SYSTEM

There should be a good filing system whereby all forms, documents and papers should bear reference to each other, and any information needed can be obtained rapidly without much fumbling.

ERASURES

There should be no erasure allowed in the books of account. If any entries have been erroneously made or any figures wrongly entered, the same should not be erased or scratched out, but should be neatly ruled out in red ink and duly initialled, and the correct ones entered over them. As far as possible, all rectifications of errors should be done by means of Journal entries.

PERIODICAL STATEMENTS

In order to enable a business to be successfully managed, it is necessary that those in management be kept well informed at frequent intervals as to the progress of the business and its financial condition. Several statements will, therefore, have to be prepared from time to time so as to disclose most valuable information on the following matters:—

- (1) Whether the sales are on the increase or decrease, and whether the buying has been carried on at favourable moments;
- (2) Which of the departments of the business are progressing favourably and which are working at a loss, and how the percentage of gross profit actually earned in each department compares with the percentage as originally intended to be earned;
- (3) How the productive wages and the direct materials consumed from week to week compare in relation to the output;
- (4) What increase or decrease there has been in expenditure under any of the heads, and the reasons that account for such fluctuations;
- (5) Whether there has been any theft or leakage of goods; and
- (6) Whether the concern has the necessary working capital at its disposal, or whether it is hampered for want of sufficient capital.

The information on these and several other points will enable those at the helm of affairs to maintain a close grip on the details of the business, which is highly essential, if the management is to prove successful.

CONCLUSIONS

It would not be out of place to mention here that in order to make a system of internal check and control as indicated above a success, it is important that every detail thereof should be rigidly enforced, and it would be the duty of those enjoying higher positions to take a keen interest in seeing that each link in the system works in perfect harmony without any friction.

There is a further duty which the proprietors of the business or those in management owe to those employed under them, and that is, not to place unnecessary temptations in the way of others through their own slackness. Further, it is equally their duty to see that every member of the staff is well paid, that skill, efficiency and initiative are amply rewarded by advancement, and thus, by promoting the welfare of the employees, to ensure their personal interest and co-operation in the success of the business.

The above precautions are, after all, directed chiefly against employees enjoying subordinate positions and do not touch the carefully planned and the deliberate acts of dishonesty by those in full control and management of the business. The manipulation of accounts by such persons would have for its object the presentation of quite a different state of financial affairs from what would be justified by actual facts. It is here that a well conducted audit comes in useful so as to serve as a great restraining influence on those with dishonest intentions.

CHAPTER V

FIRST YEAR'S AUDIT OF A PUBLIC COMPANY

(Under the Indian Companies Act, 1913- 1936)

THE INDIAN COMPANIES (AMENDMENT) ACT, 1936

The passing of the Indian Companies Amendment Act, 1936, marks an important advance towards the development of Joint Stock Companies working in British India. The Act follows closely upon the lines of English Legislation, and introduces considerable changes of a far-reaching character affecting the promotion, working and management of Public Companies in India. While the powers of the directors and managing agents have been considerably curtailed by the New Act, the shareholders have been granted better privileges, wider powers of control and greater facilities for acquiring a more intimate and fairly accurate knowledge of the inner working and finances of their company. As there are numerous matters in Company Law which constantly affect the auditor in course of his professional work, it is absolutely essential that he should be fully conversant with such portions thereof as bear directly upon his duties. It has, therefore, been thought desirable to briefly enumerate the several obligations and restrictions imposed on Public Companies, under the New Act. The more important Sections of the Act as directly affect the auditors in relation to their duties have been fully cited in appropriate places throughout the Chapters on Company Audit, with a view to facilitate reference.

Amongst the more important changes brought about by the New Act may be mentioned the following:—

1. The provisions relating to the contents of the Prospectus have been altered substantially so as to embody within that document several additional matters as would help the prospective shareholders to form their own opinion as to the desirability or otherwise of taking up the shares of the company.

2. The basis for fixing up of the minimum subscription has been defined, and it must now be of such an amount as would provide not only for the acquisition of the fixed assets and the initial preliminary expenses, but also the working capital of the company.

3. The Act prohibits the use of moneys received from prospective shareholders until receipt of Certificate for Commencement of Business.

4. It provides for the compulsory inclusion of several clauses of Table A in the Articles of Association of every company.

5. It regulates the appointment and dismissal of directors, and while imposing on them fresh responsibilities and obligations, it places restrictions on the powers of management they have hitherto enjoyed.

6. It introduces, for the first time, new provisions in regard to the rights and responsibilities of the managing agents, and imposes due restric-

tions on their powers of management. The appointment of the managing agents, their remuneration, and any variation in the managing agency agreement are made subject to a resolution of the general meeting.

7. An independent Board of Directors is now rendered possible by limiting the managing agents' right of nomination to one-third of the total number of directors.

8. A very important and highly desirable right has been conferred on the shareholders in enabling them to remove any director before the expiry of his term of office, by an Extraordinary Resolution.

9. There is provision for fuller information to be disclosed to the shareholders in the Statutory Report than hitherto.

10. The Prescribed Form of Balance Sheet has been elaborated and improved upon so as to present more detailed information than hitherto.

11. The Act provides for the compulsory compilation, circulation and filing of the Profit & Loss Account along with the Balance Sheet.

12. It inserts a new provision for the compulsory inclusion of Directors' Report with their opinion as to the state of the company's affairs together with their recommendations with regard to Dividends and Reserves to be attached to every Balance Sheet.

13. It enforces maintenance of a Register of Contracts in which Directors are interested, and its inspection by shareholders during business hours. This will undoubtedly serve to make the directors more cautious in their dealings with the company.

14. It entitles the existing shareholders to participate in any new issue of shares by the directors, as a matter of right.

15. The shareholders have been henceforth empowered to inspect the minutes of the general meetings during business hours and to obtain a certified copy thereof on payment of nominal charges.

16. They have also been authorised to obtain copy of the Register of Members within ten days of their application to the company.

17. A fresh duty is imposed on the auditors to report to the shareholders whether in their opinion the books of account have been properly maintained by the company or not.

18. A new privilege of receiving notice of general meetings and to attend general meetings, if they so think it necessary, has been conferred on the auditors.

19. The issue of shares at a discount and the issue of Redeemable Preference Shares are authorised, for the first time, under certain conditions.

20. Provisions relating to Holding Companies and Banking Concerns have also been included.

21. The Registrar of Joint Stock Companies is empowered to investigate cases of fraud brought to his notice.

It is clear from the above that the changes are vast and varied, and the company auditor who is anxious to conscientiously fulfil his obligations to the shareholders by the conduct of an efficient audit must necessarily make an exhaustive study of the substantial and numerous alterations brought about by the Amending Act, and which bear materially upon the duties he has to perform.

As several important points peculiar to companies specially arise in certifying the first Balance Sheet of a company, it has been thought desirable to give, in this Chapter, a sufficiently good outline of the matters that an auditor will have necessarily to face in the due performance of his duties, in this connection.

APPOINTMENT AND REMUNERATION OF AUDITORS

Section 144 is of special interest to auditors as it deals with their qualification, appointment, remuneration and removal.

This Section provides as under:—

Section 144. (1) No person shall be appointed or act as an auditor of any company other than a private company not being the subsidiary company of a public company unless he holds a certificate from the Governor-General-in-Council entitling him to act as an auditor of companies :

a. Provided that a firm whereof all the partners practising in India hold such certificates may be appointed by its firm-name to be auditor of a company, and may act in its firm-name.

(2) The Governor-General-in-Council may, by notification in the *Gazette of India* and after previous publication, make rules providing for the grant, renewal or cancellation of such certificates and prescribing conditions and restrictions for such grant, renewal or cancellation :

Provided that nothing contained in such rules shall preclude any person from being granted a certificate merely by reason that he does not practise as a public accountant.

(2A) In particular, and without prejudice to the generality of the foregoing power, such rules may—

- (a) provide for the maintenance of a Register of Accountants entitled to apply for such certificates ;
- (b) prescribe the qualifications for enrolment on the Register and the fees therefor ;
- (c) provide for the examination of candidates for enrolment, and prescribe the fees to be paid by examinees ;
- (d) prescribe the circumstances in which the name of any person may be removed from or restored to the Register ;
- (e) provide for the establishment, constitution and procedure of an Indian Accountancy Board, consisting of persons representing the interests principally affected or having special knowledge of accountancy in India, to advise him on all matters of administration relating to accountancy, and to assist him in maintaining the standards of qualification and conduct of persons enrolled on the Register ; and
- (f) provide for the establishment, constitution and procedure of local accountancy boards at such centres as the Governor-General-in-Council may select, to advise him and the Indian Accountancy Board on any matter that may be referred to them.

(2B) The holder of a certificate granted under this section shall be entitled to be appointed and act as an auditor of companies throughout British India.

(3) Every company shall at each annual general meeting appoint an auditor or auditors to hold office until the next annual general meeting.

(4) If an appointment of an auditor is not made at an annual general meeting, the Local Government may, on the application of any member of the company, appoint an auditor of the company for the current year, and fix the remuneration to be paid to him by the company for his services.

(5) The following persons ; that is to say,

(i) a director or officer of the company ; and

(ii) a partner of such director or officer ; and

(iii) in the case of a company other than a private company not being the subsidiary company of a public company, any person in the employment of such director or officer ; and

(iv) any person indebted to the company, shall not be appointed auditor of the company and if any person after being appointed auditor becomes indebted to the company his appointment shall thereupon be terminated.

(6) A person, other than a retiring auditor, shall not be capable of being appointed auditor at an annual general meeting unless notice of an intention to nominate that person to the office of auditor has been given by a member of the company to the Company not less than fourteen days before such annual general meeting, and the company shall send a copy of any such notice to the retiring auditor, and shall give notice thereof to its members either by advertisement or in any other mode allowed by the articles not less than seven days before the annual general meeting ;

Provided that, if after notice of the intention to nominate an auditor has been given to the company, an annual general meeting is called for a date fourteen days or less after the notice has been given, the requirements of this section as to time in respect of such a notice shall be deemed to have been satisfied, and the notice to be sent or given by the company may, instead of being sent or given within the time required by this section, be sent or given at the same time as the notice of the annual general meeting.

(7) The first auditors of the company may be appointed by the directors before the statutory meeting, and if so appointed shall hold office until the first annual general meeting, unless previously removed by a resolution of the members of the company in general meeting, in which case such members at that meeting may appoint auditors.

(8) The directors may fill any casual vacancy in the office of auditor, but while any such vacancy continues, the surviving or continuing auditor or auditors (if any) may act.

(9) The remuneration of the auditors of a company shall be fixed by the company in general meeting, except that the remuneration of any auditors appointed before the statutory meeting, or to fill any casual vacancy, may be fixed by the directors.

The main requirements of this Section are as under:—

(1) A person desirous of acting as an auditor of a public company (AND A PRIVATE COMPANY WHICH IS SUBSIDIARY) must obtain a certificate from the Governor-General-in-Council entitling him to act as an auditor.

(2) No such qualification is required for auditors of private companies.

(3) The first auditor of a company may be appointed by the directors, before the Statutory Meeting, and he will be entitled to remain in office till

the first annual general meeting, unless he is previously removed by the shareholders in general meeting.

(4) The following persons cannot act as auditors to a company:—

(a) A director or officer of a company;

(b) A partner of such director or officer; and

(c) In case of a public company or a private company, which is a subsidiary to such a company, any person in the employment of such director or officer.

(5) An auditor is disqualified if he becomes indebted to the company.

(6) In case of any casual vacancy arising in the office of an auditor before the annual general meeting owing to death or retirement, such vacancy may be filled up by the directors.

(7) Only a retiring auditor is eligible for re-election at the annual general meeting of the company, unless notice to nominate some other person has been given by any shareholder to the company not less than 14 days before the meeting, and the company has sent 7 days' notice to the retiring auditor and to the shareholders. The effect of this clause is to prevent the directors from removing the retiring auditors without the knowledge of the shareholders.

(8) The remuneration of the auditors will be fixed by the company in general meeting, except in the case of first auditors appointed by the directors before the first annual general meeting or on occasions when any casual vacancy is filled up by the directors, in which cases, the latter will fix their remuneration.

(9) Where no auditor is appointed at an annual general meeting, the Local Government is empowered to appoint one for the current year and to fix his remuneration.

Where the auditor is appointed by the Directors prior to the first annual general meeting, he should obtain from the secretary of the company a copy of the Board's Minute regarding his appointment in order to ensure its validity. If appointed by the company in general meeting, he should obtain a copy of the Shareholders' Resolution. Similarly, he would require for his satisfaction a copy of the Board's Minute, when his appointment is made by the Directors to fill up any casual vacancy arising from the death or retirement of the existing auditor.

Where the appointment is occasioned on removal of the previous auditor by the company in General Meeting, he should not only ask for a copy of the minute recording the Shareholders' Resolution, but should also ascertain if proper notice of his nomination has been given to the members as also to the previous auditor, as otherwise, his appointment would be invalid. In this latter case, he should make due enquiries and put himself in communication with the old auditor with a view to ascertain the reasons for the change.

before accepting such appointment, in order to obviate any breach of professional etiquette on his own part.

It must be observed that an auditor to a company is the representative of the shareholders. He is appointed to watch their interests and to ascertain after an exhaustive enquiry that the directors have rendered a true and faithful account of their dealings. It is his duty to report to the shareholders on the exact financial condition of the business as may be ascertained by him on a most careful and critical examination of the books of account, vouchers and documents of the company, without fear or favour. It happens usually that in course of his work he is brought into close and constant touch with the managing agents and the directors whose transactions he has to investigate, but he should under no circumstance allow himself to be dictated or guided by them in the rightful performance of his duties.

LIST OF BOOKS AND LEGAL DOCUMENTS

Usually, before commencing an audit, it is advisable to obtain from the secretary, a complete list of all the statutory, statistical and financial books kept. This list is useful, as it prevents the possible omission of any book when checking the accounts, and rests on the company's officers the liability incurred by the non-production of a book.

The auditor must then study the Memorandum and Articles of Association, the Prospectus and Contracts, making special notes of all matters dealing with books and accounts, as these documents form the very foundation of the work that he has to perform. He must see what exceptional duties, if any, are cast upon him by the Articles of the Company, as ignorance of any special duties imposed is no legal justification for the non-performance of them.

MEMORANDUM OF ASSOCIATION

Section 6 of the Act requires every company limited by shares to have a Memorandum of Association as under:—

Section 6.—In the case of a company limited by shares—

- (1) the memorandum shall state—
 - (i) the name of the company, with "Limited" as the last word in its name;
 - (ii) the province in which the registered office of the company is to be situate;
 - (iii) the objects of the company;
 - (iv) that the liability of the members is limited;
 - (v) the amount of share capital with which the company proposes to be registered, and the division thereof into shares of a fixed amount;
- (2) no subscriber of the memorandum shall take less than one share;
- (3) each subscriber shall write opposite to his name the number of shares he

takes.

The Memorandum of Association declares the constitution and defines the objects of the Company. The most important clause affecting the auditor is the one relating to the objects of the Company. As this clause sets out the nature of the Company's business and determines the limits to its powers,

any transaction done by the Company outside the scope of its objects clause is *ultra vires*. It will, therefore, be the duty of the auditor to report the fact to the shareholders, if he finds that the lines as laid down by the Memorandum have been deviated from or that the Company has exceeded its powers. The conditions contained in the Memorandum cannot be altered except in the manner and to the extent as provided by the Act. The auditor must also refer to the Capital Clause in order to ascertain that the issued share capital is not in excess of the Authorised Capital as declared by the Memorandum, unless there is a Resolution increasing the original share capital of the Company.

ARTICLES OF ASSOCIATION

Every Company is also required by the Act to have another document called the Articles of Association registered along with the Memorandum. (Sec. 17.)

The Articles of Association may be defined as the regulations framed for the internal management of the company, and by which the objects and powers of the Company are carried into effect. They constitute a contract between the Company on the one hand and the shareholders individually on the other and also between the members *inter se*. They are subordinate to and are controlled by the Memorandum.

The Articles usually deal with the following points:—

- (1) Share capital and its division into various classes.
- (2) Rights attaching to the different classes of shares.
- (3) Call on shares.
- (4) Extent of borrowing powers.
- (5) Payment of commission on placing shares.
- (6) Transfer and Transmission of shares.
- (7) Lien on shares.
- (8) Forfeiture of shares.
- (9) Conversion of shares into stock.
- (10) Share warrants.
- (11) Alteration of capital.
- (12) Directors, their number, powers, duties, qualification, remuneration, disqualification, and rotation.
- (13) Proceedings of Directors.
- (14) Managing Agents, their powers, duties and remuneration.
- (15) Proceedings at Meetings.
- (16) General and Extraordinary Meetings.
- (17) Voting rights of members.
- (18) Notices to members.
- (19) The Common Seal.
- (20) Dividends and Reserves.
- (21) Accounts and Audit, etc.

A Company may by its Articles of Association adopt all or any of the regulations contained in TABLE A, which embodies a model set of Articles set forth in the First Schedule to the Act.

In case of a Company limited by shares, if the Articles are not registered along with the Memorandum, the whole of the regulations contained in TABLE A will apply. If the Articles are registered, then the regulations in TABLE A will apply in so far as the Articles do not exclude or modify them.

A Company may, by SPECIAL RESOLUTION, alter or add to its Articles, and any alteration or addition so made shall be equally valid and can in like manner be altered by special resolution. Where any alteration is made in the Memorandum or the Articles of a Company, every subsequent copy thereof issued shall contain such alteration.

An important change brought about by the amendment of SECTION 17 is to make certain regulations of Table A compulsory for all companies, irrespective of whether Table A is adopted or excluded.

As the provisions in the Articles contain the authority for and prescribe the procedure to be followed in respect of many important matters affecting the accounts as above indicated, an auditor must thoroughly familiarise himself with the Articles of the Company under audit in order to ascertain how far the regulations contained in Table A have been excluded. He must be on the constant look-out to make sure that the entire proceedings and working of the Company are in due accord with the terms of its Articles. Any clause in the Articles restricting the duties of the auditor in any way will be void. He should further see that all alterations in the Articles are supported by Special Resolutions, and that there are no Articles in contravention of the Act.

In the first year's audit, the auditor will find it very useful to make notes in the Audit Note Book of all such Articles as would directly affect the accounts. Any subsequent additions or alterations to such Articles will have to be similarly noted.

CONTENTS OF THE PROSPECTUS

Section 93 of the Act enacts as under in regard to the contents of every Prospectus issued by a Public Company:--

Section 93. (1) Every prospectus issued by or on behalf of a company, or by or on behalf of any person who is or has been engaged or interested in the formation of the company, shall state---

- (a) the contents of the memorandum, with the names, descriptions and addresses of the signatories and the number of shares subscribed for by them respectively; and the number of founders or management or deferred shares (if any) and the nature and extent of the interest of the holders in the property and profits of the company and the number of redeemable preference shares intended to be issued with the date or, where no date is fixed, the period of notice required and the proposed method of redemption; and

- (b) the number of shares (if any) fixed by the articles as the qualification of a director, and any provision in the articles as to the remuneration of the directors ; and
- (c) the names, descriptions and addresses of the directors or proposed directors and of the managers or proposed managers and managing agents or proposed managing agents (if any) and any provision in the articles or in any contract as to the appointment of managers or managing agents and the remuneration payable to them ; and
- (d) the minimum subscription on which the directors may proceed to allotment, and the amount payable on application and allotment on each share ; and in the case of a second or subsequent offer of shares the amount offered for subscription on each previous allotment made within the two preceding years, and the amount actually allotted, and the amount (if any) paid on the shares so allotted ; and
- (e) the number and amount of shares and debentures which within the two preceding years have been issued, or agreed to be issued, as fully or partly paid up otherwise than in cash, and in the latter case the extent to which they are so paid up, and in either case the consideration for which those shares or debentures have been issued or agreed to be issued ; and
- (ee) where any issue of shares or debentures is underwritten, the names of the underwriters, and the opinion of the directors that the resources of the underwriters are sufficient to discharge the underwriting obligations ; and
- (f) the names and addresses of the vendors of any property purchased or acquired by the company, or proposed so to be purchased or acquired, which is to be paid for wholly or partly out of the proceeds of the issue offered for subscription by the prospectus, or the purchase or acquisition of which has not been completed at the date of issue of the prospectus, and the amount payable in cash, shares or debentures to the vendor, and where there is more than one separate vendor or the company is a sub-purchaser, the amount so payable to each vendor : Provided that where the vendors or any of them are a firm, the members of the firm shall not be treated as separate vendors ; and
- (ff) where any property referred to in clause (f) has within the two years preceding the issue of the prospectus been transferred by sale, the amount paid by the purchaser at each such transfer so far as the information is available and, where any such property is a business, the profits accruing from such business during each of the three years immediately preceding the issue of the prospectus or during each year of the existence of the business if less than three years so far as the information is available. A balance sheet of the business concerned made up to a date not more than ninety days before the date of the issue of the prospectus shall be appended to the prospectus ; and
- (g) the amount (if any) paid or payable as purchase-money in cash, shares or debentures, for any such property as aforesaid, specifying the amount (if any) payable for goodwill ; and
- (h) the amount (if any) paid within the two preceding years or payable, as commission for subscription or agreeing to subscribe, or procuring or agreeing to procure subscriptions, for any shares in, or debentures of, the company, or as discount in respect of shares issued, showing separately the amount, if any, so paid to the managing agents : Provided that it shall not be necessary to state the commission payable to sub-underwriters ; and
- (i) the amount or estimated amount of preliminary expenses ; and
- (k) the amount paid within the two preceding years or intended to be paid to any promoter, and the consideration for any such payment ; and

- (l) the dates of, and parties to, every material contract including contracts relating to the acquisition of property to which clause (f) applies, and a reasonable time and place at which any material contract or a copy thereof may be inspected: Provided that this requirement shall not apply to a contract entered into in the ordinary course of the business carried on or intended to be carried on by the company, or to any contract (except a contract appointing or fixing the remuneration of a managing director or managing agent) entered into more than two years before the date of issue of the prospectus; and
 - (m) the names and addresses of the auditor (if any) of the company; and
 - (n) full particulars of the nature and extent of the interest (if any) of every director in the promotion of, or in the property proposed to be acquired by, the company, or, where the interest of such a director consists in being a partner in a firm, the nature and extent of the interest of the firm, with a statement of all sums paid or agreed to be paid to him or to the firm in cash or shares or otherwise by any person either to induce him to become, or to qualify him as, a director, or otherwise for services rendered by him or by the firm in connection with the promotion or formation of the company; and
 - (o) where the company is a company having shares of more than one class, the right of voting at meetings of the company conferred by, and the rights in respect of capital and dividends attached to, the several classes of shares respectively; and
 - (p) where the articles of the company impose any restrictions upon the members of the company in respect of the right to attend, speak or vote at meetings of the company or of the right to transfer shares, or upon the directors of the company in respect of their powers of management, the nature and extent of those restrictions; and
 - (q) where any part of the sums required for the matters set out in the sub-section (2) of Section 101 is to be provided out of sources other than share capital, particulars of the amount to be so provided and the sources thereof.
- (1A) Where the prospectus is issued by a company which has been carrying on business prior to the issue thereof, the prospectus shall set out the following reports in addition to the matters referred to in sub-section (1), namely:—
- (i) a report by the auditors of the company with respect to the profits of the company including its subsidiary companies, if any, so far as the information is available in each of the three financial years immediately preceding the issue of the prospectus and with respect to the rates of the dividends, if any, paid by the company on each class of shares in the company for each of the said three years giving particulars of each such class of shares on which such dividends have been paid and the source from which the dividends have been paid and particulars of the cases in which no dividends have been paid on any class of shares for any of those years, and if no accounts have been made up for any part of a period of three years ending on a date three months before the issue of the prospectus, containing a statement of that fact;
 - (ii) if the proceeds or any part of the proceeds of the issue of the shares or debentures are or is to be applied directly or indirectly in the purchase of any business, a report made by an accountant or accountants holding the certificate referred to in Section 144 who shall be named in the prospectus upon the profits of the business in respect of each of the three financial years immediately preceding the issue of the prospectus;
- Provided that if, in the case of a company which has been carrying on business for less than three years, the accounts of the company have been made up only

in respect of two years or any shorter period, this sub-section shall have effect as if references to two years or such shorter period were substituted for references to three years.

(1B) The statement referred to in clause (ff) of sub-section (1) and the report referred to in sub-section (11) with respect to the profits of a company or business shall show clearly the trading results and all charges and expenses incidental thereto excluding income or profits having no relation to the trading for the period covered and excluding also items of profit or income of a non-recurring nature but including amounts appropriated from profits to such purposes as payment of taxation or reserves.

(1C) Where any part of the sums required for the matters set out in sub-section (2) of Section 101 is to be provided out of sources other than share capital particulars of the amount to be so provided and the sources thereof.

(2) Where any such prospectus as is mentioned in this Section is published as a newspaper advertisement, it shall not be necessary in the advertisement to specify the contents of the memorandum, or the signatories thereto, and the number of shares subscribed for by them.

(3) This Section shall not apply to a circular or notice inviting existing members or debenture-holders of a company to subscribe either for shares or for debentures of the company, whether with or without the right to renounce in favour of other persons.

(4) The requirements of this Section as to the memorandum and the qualification, remuneration and interest of directors, the names, descriptions and addresses of directors or proposed directors, and of managers or proposed managers, and the amount or estimated amount of preliminary expenses, shall not apply in the case of a prospectus issued more than one year after the date at which the company is entitled to commence business :

Provided that the said requirements, except the requirement as to the amount or estimated amount of preliminary expenses, shall apply to a prospectus filed in pursuance of Section 154.

(5) Nothing in this Section shall limit or diminish any liability which any person may incur under the general law or this Act apart from this Section.

An auditor is neither concerned with the issue of nor is he responsible for the contents of the Prospectus, and he cannot be held liable for non-inclusion of any statutory information or for any mis-statement of facts, even if he has permitted his name to be mentioned therein as auditor. He will, however, have to carefully scrutinise this document in the first year's audit and note that the statements made therein in regard to the following matters correspond with the Company's Articles as also with the facts as recorded in the books of account:—

(1) The Application, Allotment and Call amounts payable on the different classes of shares issued.

(2) The qualification and remuneration of Directors.

(3) Any contract for the appointment of Managers or Managing Agents and their remuneration.

(4) The amount of Minimum Subscription on which the Directors may proceed to allotment.

(5) Particulars of any contract with the Vendors for the purchase of any property, and the amount paid or payable as purchase-money in cash,

shares or debentures, for any property or business acquired by the Company, and the amount, if any, payable for goodwill.

(6) The Underwriting Commission or Brokerage payable for placing shares.

(7) The estimated amount of Preliminary Expenses.

(8) The nature and extent of the interest of any director in the promotion of, or in the property proposed to be acquired by, the Company.

(9) The amount paid to any promoter and the consideration for such payment.

(10) The issue of Redeemable Preference Shares, if any.

(11) Particulars of any other material contracts, including contracts for issue of fully or partly-paid shares or debentures.

REPORTS BY AUDITORS IN THE PROSPECTUS

The following Reports from Auditors required to be set out in the Prospectus under Section 93 need to be noted:—

(1) Where an existing Company is about to issue further shares or debentures, the Prospectus offering the same should contain the following Reports:—

A report by the auditors of the Company stating

- (a) the profits made during each of the three preceding financial years;
- (b) the rates of dividends paid by the Company issuing the Prospectus on each class of shares for each of those three years;
- (c) the sources from which such dividends have been paid;
- (d) particulars, in cases where no dividends have been paid on any class of shares for any of those years; and
- (e) whether the accounts have been made up to a date within three months from the date of the Prospectus.

(2) If any business is to be purchased from the proceeds of the issue of such shares or debentures, there should be a report by a qualified auditor named in the prospectus on the profits of the business to be purchased, for each of the three financial years immediately preceding the issue of the Prospectus.

The statement of profits in the Prospectus and in the report of the auditor must in each case clearly set out the TRADING RESULTS of each year and all charges and expenses incidental thereto, but must exclude non-trading profits, and profits of a non-recurring nature. It must, however, include profits appropriated towards taxation or reserves.

(5) Where new shares have been issued in pursuance of the last foregoing subsection, the capital redemption reserve fund may, notwithstanding anything in this Section, be applied by the company, up to an amount equal to the nominal amount of the shares so issued, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Redeemable Preference Shares may be issued with cumulative, non-cumulative or participating rights in the profits according to the terms as laid down in the Articles. Where Redeemable Preference Shares are issued, the auditor should see that proper reference to the same is included in the Balance Sheet indicating what part of the issued capital consists of such shares, and the date on or before which they are liable to be redeemed.

ORDINARY SHARES.—The holders of Ordinary Shares have no special rights except to such dividend as may be declared with due regard to the surplus left after payment of dividends on shares having preferential rights. Sometimes, these are divided into preferred and deferred ordinary shares, and in that case, the former carry a preferential right to a stipulated percentage before any payment to the deferred shares, which in their turn are entitled to the whole or a stated portion of the surplus divisible profits.

DEFERRED OR FOUNDERS' SHARES.—These shares are usually issued to founders or promoters of the Company in consideration either of the services they have rendered or in part payment of the purchase consideration. The right to dividend and repayment of capital of these shareholders is deferred till the ordinary shareholders receive their prescribed percentage, after which they take the whole or a portion of the remaining profits.

It would be the duty of the auditor to ascertain by reference to the Prospectus and the Company's Articles, what conditions or rights attach to the various classes of shares, and that these conditions or rights have been duly complied with.

SHARE CAPITAL AUDIT

The most important duty of an auditor, however, in the first year's audit of a public company, is an exhaustive verification of the Share Capital transactions. In this connection, the auditor has to see that all the requirements of the I. C. Act, particularly SECTION 101 (placing restrictions on allotment of shares by a PUBLIC COMPANY) and SECTION 103 (placing restrictions on commencement of business by a PUBLIC COMPANY), have been strictly carried out, that the amounts received have been duly recorded in the financial and statutory books of the Company and are properly accounted for, and that the item Share Capital is finally set out in the Balance Sheet exactly in the Form as prescribed by SCHEDULE III of the Act.

RESTRICTIONS ON ALLOTMENT OF SHARES

Section 101 places the following restrictions as to allotment of shares by PUBLIC COMPANIES:—

Section 101. (1) No allotment shall be made of any share capital of a company offered to the public for subscription unless the amount stated in the prospectus as the minimum amount which in the opinion of the directors must be raised by the issue of share capital in order to provide the sums or, if any part thereof is to be defrayed in any other manner, the balance of the sum required to be provided in respect of the matters specified in sub-section (2) has been subscribed, and the sum of at least five per cent thereof has been paid to or received in cash by the company.

(2) The matters for which provision for the raising of a minimum amount of share capital must be made by the directors are the following, namely :—

- (a) the purchase price of any property purchased or to be purchased which is to be defrayed in whole or in part out of the proceeds of the issue.
- (b) any preliminary expenses payable by the company and any commission so payable to any person in consideration of his agreeing to subscribe for or of his procuring or agreeing to procure subscriptions for any shares in the company.
- (c) the repayment of any moneys borrowed by the company in respect of any of the foregoing matters, and
- (d) working capital.

(2A) The amount referred to in sub-section (1) as the amount stated in the prospectus shall be reckoned exclusively of any amount payable otherwise than in cash and is in this Act referred to as the minimum subscription.

(2B) All moneys received from applicants for shares shall be deposited and kept in a scheduled bank as defined in the Reserve Bank of India Act, 1934, until returned in accordance with the provisions of sub-section (4) or until the certificate to commence business is obtained under section 103.

(2C) In the event of any contravention of the provisions of sub-section (2B) every promoter, director or other person knowingly responsible for such contravention shall be liable to a fine not exceeding five hundred rupees.

(3) The amount payable on application on each share shall not be less than five per cent of the nominal amount of the share.

(4) If the conditions aforesaid have not been complied with on the expiration of one hundred and eighty days after the first issue of the prospectus, all money received from applicants for shares shall be forthwith repaid to them without interest and, if any such money is not so repaid within one hundred and ninety days after the issue of the prospectus, the directors of the company shall be jointly and severally liable to repay that money with interest at the rate of seven per cent per annum from the expiration of the one hundred and ninetieth day: Provided that a director shall not be liable if he proves that the loss of the money was not due to any misconduct or negligence on his part.

(5) Any condition requiring or binding any applicant for shares to waive compliance with any requirement of this section shall be void.

(6) This section, except sub-section (3) thereof, shall not apply to any allotment of shares subsequent to the first allotment of shares offered to the public for subscription.

(7) In the case of the first allotment of share capital payable in cash of a company which does not issue any invitation to the public to subscribe for its shares, no allotment shall be made unless the minimum subscription (that is to say)—

- (a) the amount (if any) fixed by the memorandum or articles and named in the statement in lieu of prospectus as the minimum subscription upon which the directors may proceed to allotment; or

- (b) if no amount is so fixed and named, the whole amount of the share capital other than that issued or agreed to be issued as fully or partly paid up otherwise than in cash ;

has been subscribed and an amount not less than five per cent of the nominal amount of each share payable in cash has been paid to and received by the company.

(8) Sub-section (7) shall not apply to a private company or to a company which has allotted any shares or debentures before the commencement of this Act.

Thus, under this Section, the directors shall not proceed to allot shares in a PUBLIC company, unless the following conditions have been complied with:—

(1) That the minimum subscription, if any, fixed by the Memorandum or Articles and named in the Prospectus, has been taken up;

(2) That the sum payable on application on each such share is not less than five per cent of the face value of the shares and has been actually received in cash by the company;

(3) That for the purpose of minimum subscription, shares subscribed for CASH ONLY should be reckoned;

(4) That all moneys received from applicants are deposited in a scheduled bank until receipt of Commencement of Business Certificate;

(5) That if no minimum subscription is mentioned, then the whole of the share capital offered for subscription should be taken up and the application money thereon should be received in cash as above;

(6) If the above conditions are not complied with within 180 days after the first issue of Prospectus, all moneys received from the applicants must be returned forthwith.

It needs to be pointed out that this section only applies to a company's first allotment of shares offered for public subscription.

The auditor should see that the allotment of shares is made by the Board in due accordance with the Act and the corresponding provisions in the Articles, at a properly constituted Board Meeting the proceedings at which are duly minuted. He should particularly see that the provisions in regard to the minimum subscription have been rigidly observed, and that the Share Application moneys have been deposited in a scheduled bank and not utilised towards any purpose until the receipt of Commencement of Business Certificate.

BASIS FOR MINIMUM SUBSCRIPTION

Under the Old Act, the fixing of the minimum subscription was left entirely to the discretion of the directors and there was nothing to prevent ridiculously low figures being fixed by the Articles of Association and stated in the Prospectus as the minimum subscription.

The New Act now lays down that in fixing the amount of minimum subscription, the directors must make provision for the following:—

- (1) The purchase price of any property acquired or to be acquired out of the proceeds of the issue of shares;
- (2) Preliminary Expenses payable by the Company;
- (3) Commission payable for procuring subscriptions of shares;
- (4) Repayment of any moneys borrowed by the Company in respect of any of the foregoing matters; and
- (5) Working Capital. SECTION 101 (2).

It would thus be no longer possible for a public company to fix an arbitrary amount as minimum subscription and to obtain a certificate of commencement of business easily.

MONEYS RECEIVED FROM PROSPECTIVE SHAREHOLDERS

Whereas under the Old Act, a company could utilise moneys received from applicants for shares even before the allotment was made, under the New Act, all such moneys have to be banked intact in a scheduled bank until the Certificate of Commencement of Business is obtained. SECTION 101 (2B).

RESTRICTIONS ON COMMENCEMENT OF BUSINESS

Section 103 reads as under:—

Section 103. (1) A company shall not commence any business or exercise any borrowing powers unless—

- (a) shares held subject to the payment of the whole amount thereof in cash have been allotted to an amount not less in the whole than the minimum subscription; and
- (b) every director of the company has paid to the company on each of the shares taken or contracted to be taken by him, and for which he is liable to pay in cash, a proportion equal to the proportion payable on application and allotment on the shares offered for public subscription or, in the case of a company which does not issue a prospectus inviting the public to subscribe for its shares, on the shares payable in cash; and
- (c) there has been filed with the registrar a duly verified declaration by the secretary or one of the directors, in the prescribed form, that the aforesaid conditions have been complied with; and
- (d) in the case of a company which does not issue a prospectus inviting the public to subscribe for its shares, there has been filed with the registrar a statement in lieu of prospectus.

(2) The registrar shall, on the filing of a duly verified declaration, in accordance with the provisions of this section certify that the company is entitled to commence business, and that certificate shall be conclusive evidence that the company is so entitled:

Provided that, in the case of a company which does not issue a prospectus inviting the public to subscribe for its shares, the registrar shall not give such a certificate unless a statement in lieu of prospectus has been filed with him.

(3) Any contract made by a company before the date at which it is entitled to commence business shall be provisional only, and shall not be binding on the company until that date, and on that date it shall become binding.

(4) Nothing in this section shall prevent the simultaneous offer for subscription or allotment of any shares and debentures or the receipt of any money payable on application for debentures.

(5) If any company commences business or exercises borrowing powers in contravention of this section, every person who is responsible for the contravention shall, without prejudice to any other liability, be liable to a fine not exceeding five hundred rupees for every day during which the contravention continues.

(6) Nothing in this section shall apply to a private company, or to a company registered before the commencement of this Act which does not issue a prospectus inviting the public to subscribe for its shares or, in so far as its provisions relate to shares, to a company limited by guarantee and not having a share capital.

The following restrictions are thus placed on the commencement of business and the exercising of borrowing powers by a PUBLIC company:—

(1) The full minimum subscription must have been allotted for payments made or to be made in cash;

(2) The directors must have paid their proper proportion of the cash value of their shares;

(3) The Secretary or a Director must have filed with the Registrar a declaration that such conditions have been complied with;

(4) Where no prospectus is issued, a statement in lieu of prospectus must have been filed with the Registrar; and

(5) The Registrar must have certified that the Company is entitled to commence business.

(6) These restrictions on commencement of business and the exercise of borrowing powers do not affect PRIVATE COMPANIES.

In the first year's audit, the auditor should see that the company has not exercised any borrowing powers prior to receipt of Certificate for Commencement of Business. As contracts made by a company before it is entitled to commence business are provisional only, it should be seen that all such contracts are duly ratified after the receipt of Business Commencement Certificate by means of Board's Resolutions properly recorded in the Board's Minute Book.

EXAMINATION OF SHARE CAPITAL TRANSACTIONS

For a thorough scrutiny of the Share Capital Transactions, the following steps are necessary:—

(1) See that the Capital issued does not exceed the Authorised Capital as shown by the Memorandum of Association.

(2) See that the Minimum Subscription has been reached prior to allotment.

(3) Check the Application Letters with the Application and Allotment Book, to see that the shares allotted have been actually applied for.

(4) See the Directors' Minute to ascertain that the allotment is in order.

(5) Vouch the moneys received on Application and Allotment as shown by the Counterfoil Receipts into the Cash Books.

(6) Check the cash received on Application and Allotment Account from the Cash Book into the Bank Pass Book and also with the entries in the Application and Allotment Book. Agree the balance of the Pass Book with the Application and Allotment Account in the Ledger.

(7) In case of Application moneys returned to applicants, check the entries in the Cash Book with the Application and Allotment Book and Pass Book, and vouch such payments with the receipts by the payees acknowledging the return of money.

(8) If any Calls have been made, see the Minutes authorising the Calls.

(9) Vouch the cash received on account of each Call from the counterfoil Receipt Books into the Cash Book.

(10) Check the Calls received as shown by the Cash Book with the Call Books and the Bank Pass Book.

(11) Check the postings of the Cash Book entries relating to the issue of shares to the Share Application, Share Allotment and Call Accounts in the financial Ledger.

(12) Check the postings of the Application and Allotment and Call Books into the Register of Members, and see that the total number of shares issued as ascertained from the latter agrees with the total number of shares as shown by the Application and Allotment Book.

(13) See that the total cash received on account of Share Capital, as ascertained from the Register of Members agrees with the credit balance on the Share Capital Account LESS debit balances of Allotment and Call Accounts, if any, in the financial Ledger.

(14) Vouch the Journal Entries relating to the issue and check their postings.

(15) Note that the Directors have taken up their qualification shares and have paid for them to the same extent as other shareholders.

(16) When shares are allotted for consideration other than cash, examine the contract constituting the allottee's title to the shares together with the minute authorising the allotment. See that such contract has been duly filed with the Registrar of Joint Stock Companies.

(17) If shares are issued at a premium, see that the premium is shown distinctly from the Share Capital.

A minute examination of the Share Capital having thus been made at the first audit, it is not necessary to check the Register of Members in detail each year, except for the purpose of checking further moneys on account of Capital, if any, received during the year.

AUDIT OF SHARE CERTIFICATES

It does not come within the province of an auditor's duties to examine the Share Certificates. An auditor may, however, be entrusted with such work, in which case, he should verify the distinctive numbers of the shares, the number of shares standing in the name of each member, and the amount paid thereon with the entries in the Register of Members.

SHARES ISSUED FOR CONSIDERATION OTHER THAN CASH

Where fully or partly paid shares are issued to the Vendors in part or full payment of the purchase consideration, the auditor should vouch the contract with the Vendors and the Board's Minute recording the allotment. The auditor should also refer to the statement in the Prospectus regarding the purchase consideration payable to the vendors and how it is to be satisfied.

Sometimes, shares are issued as fully-paid to the promoters in consideration of the whole or a part of the preliminary expenses having been borne by them. Here again, the auditor should vouch such issue with the contract with the Promoters and the Board's Minute authorising such issue.

Fully-paid shares are occasionally issued as a result of a contract with the underwriters. In such a case, the nominal value of the shares should be debited to Underwriting Commission Account. The auditor will have to verify the issue with the contract with the Underwriters and the Board's Minute. He should also consult the Company's Articles to see if such commission is authorised and if such power to pay is disclosed in the Prospectus.

In all such cases, the Journal Entries recording the issue of fully or partly paid shares must be carefully checked to see that the appropriate account is debited and the Share Capital Account is credited to the extent of the value to which the shares are considered as paid up.

The auditor should further see that the necessary contract has been reduced to writing and filed with the Registrar of Companies within the prescribed period, as required by the Act.

He should also see that the shares issued as fully or partly paid up are shown in the Balance Sheet separately from the shares issued for cash.

CALLS IN ARREAR

For a proper verification of Calls in Arrear, a list of arrears should be made out from the Register of Members or Share Ledgers and the same should be agreed with the debit balances on the Share Allotment or Share Call Accounts in the financial Ledger. The auditor should see that Calls in Arrears due from the Managing Agents or the Directors are shown specifically on the face of the Balance Sheet.

CALLS IN ADVANCE

The auditor should examine the Articles to see that the Company is duly authorised to receive calls in advance, and also to ascertain the rate of

interest payable. Calls in advance do not form part of capital, and therefore, interest can be paid on them even if there are no profits. This item should be stated separately in the Balance Sheet immediately after the Share Capital, and must not be mixed with the dividend-bearing Capital. When calls in advance bear interest, the provision in this respect should be made even if there is a loss.

UNDERWRITING COMMISSION AND BROKERAGE FOR PLACING SHARES

Section 105 of the Act lays down as under:—

Section 105. (1) It shall be lawful for a company to pay a commission to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company, if the payment of the commission is authorised by the articles and the commission paid or agreed to be paid does not exceed the amount or rate so authorised and if the amount or rate per cent of the commission paid or agreed to be paid is—

- (a) in the case of shares offered to the public for subscription, disclosed in the prospectus; or
- (b) in the case of shares not offered to the public for subscription, disclosed in the statement in lieu of prospectus, or in a statement in the prescribed form signed in like manner as a statement in lieu of prospectus and filed with the registrar and, where a circular or notice, not being a prospectus inviting subscription for the shares is issued, also disclosed in that circular or notice.

(2) Save as aforesaid and save as provided in section 105A, no company shall apply any of its shares or capital money either directly or indirectly in payment of any commission, discount or allowance, to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares of the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company, whether the shares or money be so applied by being added to the purchase-money of any property acquired by the company or to the contract price of any work to be executed for the company, or the money be paid out of the nominal purchase money or contract price, or otherwise.

(3) Nothing in this section shall affect the power of any company to pay such brokerage as it has heretofore been lawful for a company to pay, and a vendor to, promoter of, or other person who receives payment in money or shares from a company shall have and shall be deemed always to have had power to apply any part of the money or shares so received in payment of any commission, the payment of which, if made directly by the company, would have been legal under this Section.

Section 105 of the Act as above empowers a Company to pay Commission to any person for subscribing or agreeing to subscribe, or for procuring subscriptions to the shares of the Company, provided the payment and the rate per cent payable are authorised by the Articles and disclosed in the Prospectus.

The auditor must see that the rate or the amount of commission or brokerage stated has not been exceeded. that the payments of underwriting commission or brokerage on shares are made in accordance with the terms

of the articles, and that in no case has commission, which is not authorised, been paid to any person.

The agreement with the underwriters must be inspected, and it should be seen that the necessary application deposits and allotment and call moneys in respect of the shares they have been called upon to take over have been duly received from them. The Board's Minute regarding the allotment to the underwriters must be examined and the payment of commission to them must be verified with their receipts. Where fully or partly paid shares have been issued to the underwriters in satisfaction of their commission, the auditor must verify the same with the Board's Minute and see that the contract in this behalf has been filed with the Registrar of Joint Stock Companies.

In regard to the brokerage paid, the auditor should examine the original Application Forms to see that they bear the names of the brokers through whom the shares have been subscribed. He should compare these with the Brokerage Lists as passed by the Board and ascertain that the amount of brokerage payable to each broker has been properly arrived at. The amount paid to individual broker must be vouched with his acknowledgment.

The amount paid for underwriting commission or brokerage on shares must be specifically disclosed in the Balance Sheet until written off.

In order to ensure that the contract for underwriting of shares or debentures is undertaken by a firm of standing, the New Act now makes it compulsory that where any issue of shares or debentures is underwritten, the names of the underwriters, and the opinion of the directors that the resources of the underwriters are sufficient to enable them to discharge their obligations, must be clearly stated in the Prospectus. (SECTION 93.)

INTEREST OUT OF CAPITAL DURING CONSTRUCTION

Section 107 empowers a company to pay interest out of capital in certain cases and under certain conditions, thus:—

Section 107.—Where any shares of a company are issued for the purpose of raising money to defray the expenses of the construction of any works or buildings or the provision of any plant which cannot be made profitable for a lengthened period, the company may pay interest on so much of that share capital as is for the time being paid up for the period and subject to the conditions and restrictions in this section mentioned, and may charge the same to capital as part of the cost of construction of the work or building, or the provision of plant :

Provided that—

- (1) no such payment shall be made unless the same is authorised by the articles or by special resolution ;
- (2) no such payment, whether authorised by the articles or by special resolution, shall be made without the previous sanction of the Local Government, which sanction shall be conclusive evidence for the purposes of this section that the shares of the company, in respect of which such sanction is given, have been issued for a purpose specified in this section ;

- (3) before sanctioning any such payment, the Local Government may, at the expense of the company, appoint a person to inquire and report to such Local Government as to the circumstances of the case, and may, before making the appointment, require the company to give security for the payment of the costs of the inquiry ;
- (4) the payment shall be made only for such period as may be determined by Local Government ; and such period shall in no case extend beyond the close of the half-year next after the half-year during which the works or buildings have been actually completed or the plant provided ;
- (5) the rate of interest shall in no case exceed four per cent per annum or such lower rate as the Governor General in Council may, by notification in the Gazette of India, prescribe ;
- (6) the payment of the interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid ;
- (7) the accounts of the company shall show the share capital on which, and the rate at which, interest has been paid out of capital during the period to which the accounts relate ;
- (8) nothing in this section, shall affect any company to which the Indian Railway Companies Act, 1895, or the Indian Tramways Act, 1902, applies.

If any interest has been paid on the Share Capital during the construction of works or buildings, the auditor will have to satisfy himself that the above requirements of the Act have been duly carried out, viz.:

(1) That the payment is authorised by the Articles or by Special Resolution;

(2) That the sanction of the Local Government has been obtained for the purpose;

(3) That the payment is made only for such period as may be determined by the Local Government;

(4) That the Interest does not exceed the authorised rate of four per cent in any case; and

(5) That the amount of interest thus paid and the Share Capital on which it is so paid are clearly disclosed in the Balance Sheet.

The Interest thus paid out of Capital is allowed to be capitalised as part of the cost of construction of works or building.

FORFEITURE OF SHARES

The power to declare shares forfeited for non-payment of calls made is usually vested in the directors under the Company's Articles of Association. The conditions and mode of forfeiture are clearly defined therein, and it should be seen that the directors have faithfully exercised the power vested in them, in the best interests of the Company.

When shares are forfeited, the auditor should examine the Articles to see if the directors have the necessary power to forfeit, and must satisfy himself that proper procedure, as required by the Articles, has been adopted,

by reference to the Directors' Minutes. He should also ascertain that the entries in the books in regard to the forfeiture have been properly made.

On a forfeiture of shares, the Share Capital Account would be debited with the amount called up upon the shares forfeited, the calls due upon these shares but unpaid would be credited to their respective Call Accounts, and the amount already received on the forfeited shares would be credited to Forfeited Shares Account. These shares can be re-issued at a discount provided such discount does not exceed the amount already paid upon them by the old shareholder. Any discount thus allowed should be debited to Forfeited Shares Account. Any credit balance finally left on the Forfeited Shares Account after the re-issue of the shares will represent profit upon the forfeiture. Such a profit, however, cannot be said to have been earned in the ordinary course of the Company's business, and should not, therefore, be transferred to the Profit and Loss Account, although there is nothing in the Companies Act to prevent this being done, unless the Company's Articles forbid such a procedure. Such a credit balance can best be utilised in writing down fictitious assets like Preliminary Expenses, Underwriting Commission, Brokerage on Shares, Cost of Issue of Debentures or Discount on Issue of Debentures, or in reducing the book value of Goodwill. If there be none of these accounts to write down, the credit balance on Forfeited Shares Account may be transferred to Capital Reserve Account. If at the date of the Balance Sheet, the forfeited shares have not been re-issued, the auditor should see that the item appears under the distinct heading of Forfeited Shares Account on the liabilities side of the Balance Sheet quite apart from the Share Capital.

ISSUE OF SHARES AT A PREMIUM

When a Company carries on a successful business, the market value of its shares would usually be quoted at a premium, and, under such a circumstance, any additional Share Capital, if required, would be offered to prospective shareholders at a premium. Where Shares are issued at a Premium, the auditor should verify the particulars given in the prospectus or the circulars relating to the issue. He should also see that the premium as recorded in the Company's books agrees with the Directors' Minutes as to the issue and the allotment of shares.

Premium received on Shares is a capital gain and is usually applied in writing off or reducing items like Preliminary Expenses, Brokerage on Shares, or Goodwill, or in the absence of any such accounts, is carried to a Capital Reserve. There is no legal objection to distributing such Premium by way of dividend, unless the Company's Articles provide otherwise, although, of course, such a distribution would not be considered as financially sound. Unless there is any contrary provision in the Articles, the auditor can have no ground for objection if such premium is distributed as dividend. He should see, however, that the credit for premium, if any taken to Profit and

Loss Account or Profit and Loss Appropriation Account, is clearly indicated on the face of such Account, and is not mixed up with trading profits.

ISSUE OF SHARES AT A DISCOUNT

It is now lawful for a company to issue at a discount shares in the Company of a class already issued:

Provided that—

- (a) the issue of the shares at a discount is authorised by a resolution passed in general meeting of the company and is sanctioned by the Court;
- (b) the resolution states the maximum rate of discount (not exceeding 10% in any case) at which shares are to be issued;
- (c) not less than one year must, at the date of issue, have elapsed since the date on which the company was entitled to commence business; and
- (d) the shares to be issued at a discount must be issued within six months after the date on which the issue is sanctioned by the Court or within such extended time as the Court may allow.

Every Prospectus relating to the issue of the shares and every Balance Sheet issued by the Company subsequently to the issue of the shares must contain particulars of the discount allowed on the issue of the shares or of so much of that discount as has not been written off at the date of the issue of the document in question. (SECTION 105A).

ISSUE OF DEBENTURES

On a first issue of Debentures, the auditor will have to do the detailed checking in respect of allotment and calls in just the same way as the share allotment and calls. The detailed record would of course be maintained in the Debenture Application, Allotment and Call Registers from which the postings would be checked into the Register of Debenture-holders. The directors' minutes should be seen as to the issue.

The auditor should vouch the consideration for the Debentures, and should inspect the Debenture Trust Deed, if any, to ascertain the conditions attaching to the issue and repayment of Debentures.

The auditor should note by reference to the Articles if any restrictions are imposed on the borrowing powers of the Directors as to the total amount to be borrowed, etc., and see that these powers are not exceeded. He should see that each issue is duly authorised by the Minutes of the Directors' Meetings.

Where various classes of Debentures are issued, such as First and Second Mortgage Debentures, or First and Second Debentures, these should be distinguished in the Balance Sheet. The balances on these accounts in the

Financial Ledger should be agreed with the totals of the lists of individual balances as extracted from the Registers of Debenture-holders.

The remuneration, if any, payable to the Trustees for the Debenture-holders under the Trust Deed should be paid or provided for in the accounts.

Where the Debentures give a Charge on the assets of the Company, it should be seen that the fact is recorded in the Register of Mortgages and Charges, and that the same has been duly filed with the Registrar of Companies. The auditor should further see that such charge is clearly disclosed on the face of the Balance Sheet.

It should be seen in every case that the Interest accrued upto the date of the financial close is brought into account.

DEBENTURES ISSUED AT A DISCOUNT

When Debentures are issued at a discount, an account styled Discount on Debentures Account will be debited with the discount allowed on the issue. The Debentures Account will be credited into the books at their nominal value and will appear at that value as a liability in the Balance Sheet. The loss thus arising need not be completely written off in the year in which the Debentures are issued, since the benefit to be derived from the amount borrowed will continue till the Debentures are redeemed. Where the Debentures are redeemable at the end of a fixed period, a proportionate amount of discount should be written off out of revenue every year during which the Debentures are outstanding. The debit balance on the Discount on Debentures Account will continue to appear on the assets side of the Balance Sheet under a distinct heading until it is completely written off. Even where the Debentures are irredeemable, the Discount on Debentures should not be allowed to stand in the books permanently, but should be written off within a reasonable period.

DEBENTURES ISSUED AT A PREMIUM

Where Debentures are issued at a Premium, the amount of premium should be credited to a separate account styled Premium on Debentures Account. The treatment in accounts of Premium on Debentures should be the same as in the case of Premium on Shares. If the amount is taken credit for in the Profit and Loss Account, the auditor should consult the Company's Articles to ascertain that they do not prohibit such a procedure, and he should further see that this item is shown specifically in the Profit and Loss Account.

VERIFICATION OF VENDORS' ACCOUNT

Where a Company purchases a running business from Vendors, the verification of the Vendors' Account will call for a very close scrutiny by the auditors. The Journal entries incorporating the assets acquired and the liabilities taken over (if any) will have to be vouched with the Contract

between the Company and the Vendors. Where the purchase consideration exceeds the total value of the assets MINUS the liabilities taken over, such excess should be debited to Goodwill Account. The auditor in such a circumstance should see that the amount thus ascertained as payable for Goodwill has been so specified in the prospectus issued by the Company.

Where the purchase consideration happens to be less than the value of the net assets (i.e., assets MINUS liabilities) acquired, there will be no goodwill, and, on the contrary, the difference will represent profit on the purchase. Inasmuch as such a profit cannot be said to have been earned by the Company in the ordinary course of its business, it can best be utilised in reducing the book value of such assets as appear to have been over-stated. In the absence of this, the amount may be used towards the reduction or wiping off of any fictitious assets, if any, standing in the books. Failing this, the amount should be credited to a Capital Reserve Account not available for dividend purposes.

It happens sometimes that the Company does not take over the Book Debts from the Vendors, but agrees to collect them on their behalf and pay off the Liabilities of the Vendors from the proceeds realised. Under such a circumstance, the assets and liabilities not actually taken over should not be mixed up with the Business Purchase entry, but must be separately posted to a Vendors' Suspense Account. The auditor must see that the Book Debts collected and the liabilities paid off on behalf of the vendors are properly adjusted on the Vendors' Suspense Account. It must be seen that any loss by way of discount or bad debts on the Book Debts taken over for collection are charged to Vendors' Suspense Account. The same procedure must follow where the Book Debts are guaranteed by the Vendors. The auditor must consult the Company's contract with the Vendors in all such cases to ascertain the arrangement agreed upon.

PRELIMINARY EXPENSES

The expenses which can legitimately be included under this head are:—

- (1) Legal cost of registering the Company.
- (2) Stamp Duty and Fees on the Nominal Capital.
- (3) Fee and Stamp duties on the documents filed with the Registrar.
- (4) Cost of preparing and printing the Memorandum and Articles of Association.
- (5) Cost of preparing all preliminary agreements including stamp duties.
- (6) Cost of preparing, printing and circulating the Prospectus.
- (7) Engineers' and Valuers' fees for valuing assets proposed to be acquired.
- (8) Accountants' charges for certifying profits.

- (9) Cost of preparing and printing Share Certificates, Letters of Allotment, Debentures, Trust Deed, etc.
- (10) Cost of the first set of Books of Account, Statutory and Statistical Books and the Company's seal.
- (11) All legal charges in connection with the promotion and formation of the Company.

As the amount expended under this head is of a non-recurring nature and as it results in getting the Share Capital subscribed, it is deemed desirable not to charge the whole of it to the first year's Revenue Account but to distribute it over a reasonable number of years, say from 3 to 5 years.

It may be pointed out that there is nothing in the Companies Act to compel a Company to write off its Preliminary Expenses within any stated number of years, and the expenditure under this head may be permanently capitalised and shown as an asset in the Balance Sheet, if a Company so desires. In any case, it would be a fictitious and an intangible asset, and as the permanent capitalising of such an item cannot be said to be a sound or a prudent measure from the view-point of finance or accounting, it would seem desirable to extinguish it from the books as early as the net profits would admit.

The total amount of Preliminary Expenses or so much of it as has not been written off must be shown separately on the assets side of the Balance Sheet.

The auditor should refer to the contract with the vendors or promoters to ascertain if they have to bear either the whole or a portion of these expenses, for if so, he should see that they are properly charged to them and that the Company is not unnecessarily burdened with any portion that should rightly be borne by them. He should further closely scrutinise the account to see that only the charges connected with the promotion and floatation of the Company falling under any of the heads described above are included under this head. He should also ascertain by reference to the Prospectus that the amount estimated therein is not exceeded.

Vouchers should be seen for all the amounts expended, a strict enquiry being made where none can be produced. The usual vouchers in this connection will be solicitors' receipted bills of costs for legal services rendered, receipts from the newspapers or advertising agents for advertising and distribution of prospectus, printers' and stationers' bills and receipts, certificate of incorporation for stamp duties, and receipted bills of costs from accountants, engineers and valuers.

It needs to be pointed out that Underwriting Commission, and Brokerage or Commission for placing shares, although relating to "capital issue expenses" are required to be stated separately from the Preliminary Expenses in the Balance Sheet until written off.

STATUTORY REPORT AND AUDIT

Section 77 of the Act provides for the holding of a Statutory Meeting, the forwarding of the Statutory Report and the Audit of such Report, as under:—

Section 77. (1) Every company limited by shares and every company limited by guarantee and having a share capital shall, within a period of not less than one month nor more than six months from the date at which the company is entitled to commence business, hold a general meeting of the members of the company, which shall be called the statutory meeting.

(2) The directors shall, at least twenty-one days before the day on which the meeting is held, forward a report (in this Act referred to as the statutory report) certified as required by this section to every member of the company.

(3) The statutory report shall be certified by not less than two directors of the company or by the chairman of the directors if authorised in this behalf by the directors and shall state—

- (a) the total number of shares allotted, distinguishing shares allotted as fully or partly paid up otherwise than in cash, and stating in the case of shares partly paid up the extent to which they are so paid up, and in either case the consideration for which they have been allotted;
- (b) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;
- (c) an abstract of the receipts of the company and of the payments made thereout up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made thereout, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company showing separately any commission or discount paid on the issue or sale of shares;
- (d) the names, addresses and descriptions of the directors, auditors, managing agents and managers, if any, and secretary of the company and the changes, if any, which have occurred since the date of the incorporation;
- (e) the particulars of any contract, the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification;
- (f) the extent to which underwriting contracts, if any, have been carried out;
- (g) the arrears, if any, due on calls from directors, managing agents and managers; and
- (h) the particulars of any commission or brokerage paid or to be paid in connection with the issue or sale of shares to any director, managing agent or manager or a partner of the managing agent if the managing agent is a firm or if the managing agent is a private company a director thereof.

(4) The statutory report shall, so far as it relates to the shares allotted by the company, and to the cash received in respect of such shares and to the receipts and payments of the company, be certified as correct by the auditors of the company.

(5) The directors shall cause a copy of the statutory report certified as required by this section to be delivered to the registrar for registration forthwith after the sending thereof to the members of the company.

(6) The directors shall cause a list showing the names, descriptions and addresses of the members of the company, and the number of shares held by them respectively, to be produced at the commencement of the meeting, and to remain open and accessible to any member of the company during the continuance of the meeting.

(7) The members of the company present at the meeting shall be at liberty to discuss any matter relating to the formation of the company or arising out of the statutory report, whether previous notice has been given or not, but no resolution of which notice has not been given in accordance with the articles may be passed.

(8) The meeting may adjourn from time to time, and at any adjourned meeting any resolution of which notice has been given in accordance with the articles, either before or subsequently to the former meeting, may be passed, and the adjourned meeting shall have the same powers as an original meeting.

(9) If a petition is presented to the Court in manner provided by Part V for winding up the company on the ground of default in filing the statutory report or in holding the statutory meeting, the Court may, instead of directing that the company be wound up, give directions for the statutory report to be filed or a meeting to be held, or make such other order as may be just.

(10) In the event of any default in complying with the provisions of this section, every director of the company who is guilty of or who knowingly and wilfully authorises or permits the default shall be liable to a fine not exceeding five hundred rupees.

(11) This section shall not apply to a private company.

The important changes in regard to the Statutory Meeting and Report under Section 77 as amended, may be summarised as under:—

- (a) Section 77 applies to companies limited by shares and also to companies limited by guarantee and having a share capital.
- (b) The Statutory Meeting must be held after one month and within six months from the date the company is entitled to commence business.
- (c) The Statutory Report shall be circulated at least 21 days (instead of 10 days) before the date of the meeting, and the same may be certified by the Chairman, if so authorised by the directors.
- (d) Any commission paid on the issue or sale of shares must be shown separately from the Preliminary Expenses.
- (e) There should also be shown separately:—
 - (1) any changes that may have occurred in the personnel of the directors, auditors, managing agents or managers, since the date of incorporation;
 - (2) the extent to which underwriting contracts have been carried out;
 - (3) the arrears of calls, if any, due from directors, managing agents or managers; and
 - (4) any commission or brokerage on shares paid or to be paid to any director, managing agent or manager.

The Report must be in Prescribed Form and a copy of the same must be filed with the Registrar forthwith after the sending thereof to the members of the company.

AUDITOR'S DUTIES IN CERTIFYING STATUTORY REPORT

The Statutory Report being an abstract of cash receipts and payments of the company on capital and revenue account, it will not only require an exhaustive audit of the Share Capital transactions as fully described in the earlier portion of this Chapter, but will also necessitate complete vouching of the whole of the Cash Book entries and the balance in hand. As no Balance Sheet is required, the question of verification of the assets and liabilities will not arise, in this case.

The auditor's duties in regard to the audit of the Statutory Report may briefly be enumerated as under:—

(1) Consult the Memorandum of Association in regard to the Authorised Capital.

(2) Verify the facts disclosed in the Prospectus with the corresponding clauses in the Articles of Association in respect of the capital and its division into the general classes of shares, minimum subscription, underwriting commission and brokerage on shares.

(3) See to the proper issue of the Share Capital or Debentures in terms of the Prospectus and the Articles.

(4) Conduct an exhaustive Share Capital and Debenture Audit, as already detailed on pages 126 and 127.

(5) See that the Minimum Subscription amount as fixed by the Directors has been reached before allotment.

(6) See that the moneys received from prospective shareholders are banked intact in a Scheduled Bank and not made use of until the receipt of Commencement Certificate.

(7) Reconcile the total amount received in respect of Application, Allotment and Calls as appearing in the financial Ledger with their corresponding totals as obtained from the lists made out from Share Ledgers or Share Registers.

(8) See that the calls in arrears also similarly tally.

(9) See that the shares subscribed by the signatories to the Memorandum are duly entered in the Application and Allotment Book.

(10) See that the Directors have taken up and paid for their qualification shares to the same extent as the public.

(11) Verify the allotment of shares for consideration other than cash to vendors and others with the contracts constituting the title of the allottees to such shares, and see that the necessary contracts in this behalf have been duly filed with the Registrar.

(12) Check the record of Bank Transactions with the Pass Books and verify the closing balances with the certificates obtained from the bankers.

(13) In case of any forfeiture of shares, see that the regulations of the company in regard to same have been duly complied with.

(14) Where Redeemable Preference Shares are issued, see that the Articles authorise such an issue.

(15) Ascertain the restrictions, if any, on the borrowing powers of the company by reference to the Articles and see that these are not exceeded.

(16) Vouch proceeds of loans secured by mortgages or charges and verify these with the record in the Register of Mortgages and Charges. See that the necessary particulars have been duly filed with the Registrar.

(17) Scrutinise thoroughly all items of Capital Expenditure.

(18) Ascertain that the Preliminary Expenses, if recoverable from the promoters or vendors, have been duly recovered.

(19) Scrutinise thoroughly the items charged to Preliminary Expenses.

(20) See that the terms of underwriting contract have been duly fulfilled by the underwriters.

(21) Vouch in detail the commission and brokerage paid for placing shares or debentures.

(22) Verify the payment of underwriting commission with the contract with the underwriters and their acknowledgment.

(23) Vouch all the receipts and payments of the company upto within seven days of the Report.

(24) See that the various receipts and payments are shown in the Statutory Report under their appropriate heads.

(25) Examine the Board's Minutes in regard to:--

(a) The appointment and remuneration of the directors and managing directors;

(b) The appointment and remuneration of the managing agents;

(c) The issue of Prospectus;

(d) The ratification of the underwriting contract;

(e) The ratification of agreements with the vendors and others;

(f) The allotment of Shares and Debentures;

(g) The appointment and remuneration of Auditors;

(h) The sanction in regard to Capital Expenditure;

(i) The forfeiture of shares, if any;

(j) Resolutions in respect of Calls, if any;

(k) Allotment of shares for consideration other than cash.

The auditor should see that all the receipts and payments are well within the scope of the company's business, that they are duly authorised, and are

substantiated by proper vouchers. The above duties having been performed and the auditor, after being satisfied with the correctness of the abstract of receipts and payments, will append his certificate in the following form:—

"I hereby certify that the annexed Statutory Report of the Blank Company, Ltd., so far as it relates to the shares allotted by the Company and to the cash received in respect of such shares and to the receipts and payments of the Company is correct."

Private Companies are exempted from forwarding the Statutory Report to the members and from filing the same with the Registrar.

BOOKS OF ACCOUNT

Section 130. (1) Every company shall cause to be kept proper books of account with respect to—

- (a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place ;
- (b) all sales and purchases of goods by the company ;
- (c) the assets and liabilities of the company.

(2) The books of account shall be kept at the registered office of the company or at such other place as the directors think fit, and shall be open to inspection by the directors during business hours.

(3) In the case of a company managed by a managing agent, the managing agent, or where the managing agent is a firm or company, the partner or director of such firm or company and in any other case the director or directors who have knowingly by their act or omission been the cause of any default by the company in complying with the requirements of this section, shall in respect of such offence be liable to a fine not exceeding one thousand rupees.

It is not expressly stated as to what particular books a company should maintain, yet in order to give details of the transactions as required by the section, the following would be deemed to be necessary:—

- (a) Cash Book;
- (b) Purchase Journal;
- (c) Sales Journal;
- (d) Ledger or Ledgers having separate accounts of assets, liabilities and sources of income and expenditure; and
- (e) Journal proper.

These would of course be supplemented by such other subsidiary records as the particular nature of the business would demand.

The books of account must be kept at the company's registered office or at such other place as the directors think fit, and must be open to the inspection of the directors.

The managing agents are primarily responsible for the due compliance with the requirements of this Section, but the directors would be held liable where there are no managing agents.

As to the inspection of books of account and documents by the members, Section 17 makes the Clause 105 of Table A compulsory for every company, under which the directors are now required to declare the times and places and the conditions under which the shareholders can make such inspection.

Clause 105 of Table A, reads as under:—

“The directors shall from time to time determine whether and to what extent and at what times and places and under what conditions or regulations the accounts and books of the company or any of them shall be open to the inspection of members not being directors, and no member (not being a director) shall have any right of inspecting any account or book or document of the company except as conferred by law or authorised by the directors or by the company in general meeting.”

In regard to the maintenance of proper books of account, it is important to note that the company auditors have now to state in their report at the foot of the Balance Sheet whether the books have been so maintained, under Section 145(2) .

ANNUAL BALANCE SHEET

The requirements as to the Annual Balance Sheet are embodied in Section 131, which provides as under:—

Section 131. (1) The directors of every company shall at some date not later than eighteen months after the incorporation of the company and subsequently once at least in every calendar year lay before the company in general meeting a balance-sheet and profit and loss account or in the case of a company not trading for profit an income and expenditure account for the period, in the case of the first account since the incorporation of the company and in any other case since the preceding account, made up to a date not earlier than the date of the meeting by more than nine months or in the case of a company carrying on business or having interests outside British India by more than twelve months :

Provided that the registrar may for any special reason extend the period by a period not exceeding three months.

(2) The balance-sheet and the profit and loss account or income and expenditure account shall be audited by the auditor of the company as hereinafter provided, and the auditor's report shall be attached thereto, or there shall be inserted at the foot thereof a reference to the report, and the report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

(3) Every company other than a private company shall send a copy of such balance-sheet and profit and loss account or income and expenditure account so audited together with a copy of the auditor's report to the registered address of every member of the company at least fourteen days before the meeting at which it is to be laid before the members of the company, and shall deposit a copy at the registered office of the company for the inspection of the members of the company during a period of at least fourteen days before that meeting.

The directors of every company are now required to have the first Balance Sheet and Profit and Loss Account made out within 18 months from the date of incorporation of the company, and subsequently thereafter once

at least in every calendar year, and lay the same before the shareholders in general meeting.

This Section, for the first time, makes the preparation, audit and circulation of the Profit and Loss Account along with the Balance Sheet compulsory for every company. In case of non-trading companies, an Income and Expenditure Account has to accompany the Balance Sheet.

The accounts to be placed before the General Meeting must be made up to a period not exceeding 9 months from the date of the meeting, or 12 months where the company carries on business outside British India. Under special circumstances, the Registrar has power to extend the period by 3 months.

The Balance Sheet and Profit and Loss Account or the Income and Expenditure Account are required to be audited by the auditor of the company who has to append his report thereto. A copy of such accounts must be kept at the Registered Office of the Company for the inspection of the members for at least 14 days before the general meeting.

Every company other than a private company is required to send the audited Balance Sheet and Profit and Loss Account (or Income and Expenditure Account) together with the auditor's report to the registered address of every member, at least 14 days before the date of the general meeting. The auditor's report must also be read before the shareholders in general meeting and must be kept open to inspection by any member attending the meeting.

DIRECTORS' REPORT ON THE COMPANY'S AFFAIRS

Section 131A, inserts a new provision which compulsorily requires that the directors' report must be attached to every Balance Sheet and such Report must include their opinion as to the state of the company's affairs as also their recommendations with regard to dividends and reserves. The Report may be signed by the Chairman, if so authorised. Prior to the Amending Act, such a Report has always accompanied a published Balance Sheet, but that was a matter of practice. The Section enacts as under:—

Section 131A. (1) The directors shall make out and attach to every balance-sheet a report with respect to the state of the company's affairs, the amount, if any, which they recommend should be paid by way of dividend and the amount, if any, which they propose to carry to the Reserve Fund, General Reserve or Reserve Account shown specifically on the balance-sheet or to a Reserve Fund, General Reserve or Reserve Account to be shown specifically in a subsequent balance-sheet.

(2) The report referred to in sub-section (1) may be signed by the chairman of the directors on behalf of the directors if authorised in that behalf by the directors.

(3) The provisions of sub-section (3) of section 130 shall apply to any person being a director who is knowingly and wilfully guilty of a default in complying with this section.

CONTENTS OF BALANCE SHEET

Section 132 provides for the contents of the Balance Sheet to be as under:—

Section 132. (1) The balance-sheet shall contain a summary of the property and assets and of the capital and liabilities of the company giving such particulars as will disclose the general nature of those liabilities and assets and how the value of the fixed assets has been arrived at.

(2) The balance-sheet shall be in the form marked F in the Third Schedule or as near thereto as circumstances admit.

(3) The profit and loss account shall include particulars showing the total of the amount paid whether as fees, percentages or otherwise to the managing agent, if any, and the directors respectively as remuneration for their services and, where a special resolution passed by the members of the company so requires, to the manager, and the total of the amount written off for depreciation. If any director of the company is by virtue of the nomination, whether direct or indirect, of the company, a director of any other company, any remuneration or other emoluments received by him for his own use, whether as a director of, or otherwise in connection with the management of, that other company, shall be shown in a note at the foot of the account or in a statement attached thereto.

From the Form F of Balance Sheet given on pages 148-151, it would be seen that the classification and grouping of assets and liabilities have been considerably amplified, so as to make a fuller disclosure to the shareholders regarding the true financial condition of the business than was done under the Old Form. Every Balance Sheet issued by a company must comply, as far as possible, with the Form F and must disclose the fullest particulars as stated therein.

The Profit and Loss Account is required to show specially among other things the remuneration paid to the managing agents as also the directors and the total amount written off as depreciation.

If a director of a company is by virtue of nomination, a director of any other company, then the remuneration received from the latter company must be stated by way of a foot-note.

CONTENTS OF PROFIT AND LOSS ACCOUNT

Besides the particulars required as above, Clause 107 of Table A, which must compulsorily be included in the Articles of every company, requires the following further details to be shown in the Profit and Loss Account:—

“The profit and loss account shall (in addition to the matters referred to in sub-section (3) of Section 132 of the Indian Companies Act, 1913), show, arranged under the most convenient heads, the amount of gross income, distinguishing the several sources from which it has been derived, and the amount of gross expenditure distinguishing the expenses of the establishment, salaries and other like matters. Every item of expenditure fairly chargeable against the year's income shall be brought into account, so that a just balance of profit and loss may be laid before the meeting, and, in cases where any item of expenditure which may in fairness be distributed

over several years has been incurred in any one year, the whole amount of such item shall be stated, with the addition of the reasons why only a portion of such expenditure is charged against the income of the year."

AUTHENTICATION OF PERIODICAL ACCOUNTS

In this connection, Section 133 lays down as under:—

Section 133. (1) Save as provided by sub-section (2) the balance-sheet and profit and loss account or income and expenditure account shall—

- (i) in the case of a banking company, be signed by the manager or managing agent (if any) and where there are more than three directors of the company, by at least three of those directors and, where there are not more than three directors, by all the directors;
- (ii) in the case of any other company, be signed by two directors or, when there are less than two directors, by the sole director and by the manager or managing agent (if any) of the company.

(2) When the total number of directors of the company for the time being in British India is less than the number of directors whose signatures are required by sub-section (1), then the balance-sheet and profit and loss account or income and expenditure account shall be signed by all the directors for the time being in British India, or, if there is only one director for the time being in British India, by such director, but in such a case there shall be subjoined to the balance-sheet and profit and loss account or income and expenditure account a statement signed by such directors or director explaining the reason for non-compliance with the provisions of sub-section (1).

(3) If any default is made in laying before the company or in issuing a balance-sheet and profit and loss account or income and expenditure account as required by section 131 or if any balance-sheet and profit and loss account or income and expenditure account is issued, circulated or published which does not comply with the requirements laid down by and under section 131, section 132, section 132A and this section, the company and every officer of the company who is knowingly or wilfully a party to the default shall be punishable with fine which may extend to five hundred rupees.

This section provides that in case of ordinary companies, the Balance Sheet and Profit and Loss Account should be signed by two directors, or where there are less than two directors, by the sole director as also by the manager or managing agent of the company; and that in case of a banking company, by at least three directors and by the manager or managing agent. When the total number of directors present in India is less than the required number, the accounts must be signed by those present, or when there is only one director present, then by such director alone. The director or directors signing in such a circumstance must append a statement explaining the reason why the accounts could not be signed by the requisite number of directors.

BALANCE SHEET TO BE FILED WITH THE REGISTRAR

Section 134 requires the Profit and Loss Account and the Balance Sheet to be filed with the Registrar within 21 days after the annual general meeting along with the Annual List of Members and Summary of Share Capital. This Section states as under:—

Section 134. (1) After the balance-sheet and profit and loss account have been laid before the company at the general meeting, a copy of the balance-sheet signed by the manager or secretary of the company shall be filed with the registrar at the same time as the copy of the annual list of members and summary prepared in accordance with the requirements of section 32.

(2) If the general meeting before which a balance-sheet is laid does not adopt the balance-sheet, a statement of that fact and of the reasons therefor shall be annexed to the balance-sheet and to the copy thereof required to be filed with the registrar.

(3) This section shall not apply to a private company.

(4) If a company makes default in complying with the requirements of this section, the company and every officer of the company who knowingly and wilfully authorises or permits the default shall be liable to the like penalty as is provided by section 32 for a default in complying with the provisions of that section.

RIGHT OF MEMBERS TO COPIES OF ANNUAL ACCOUNTS

Section 135 entitles any shareholder to be furnished with a copy of the Profit and Loss Account and the Balance Sheet together with the Auditor's Report on payment of a prescribed charge as under:—

Section 135. Save as otherwise provided in this Act, any member of a company shall be entitled to be furnished with copies of the balance-sheet and the profit and loss account or the income and expenditure account and the auditor's report at a charge not exceeding six annas for every hundred words or fractional part thereof.

AUDIT OF FIRST BALANCE SHEET

The first annual audit of a public company will call for the auditor's close and careful scrutiny not only of the several special matters as have already been fully enumerated in this Chapter but will also require a most critical examination and verification of all the assets and liabilities set forth in the Balance Sheet in order to enable him to give a "clean" report to the shareholders.

The items of capital outlay on lands, buildings, machinery, plant and other fixed assets will have to be carefully scrutinised and vouched to ascertain that they really represent capital expenditure, that there is no unauthorised payment, that the assets have been actually acquired by the company and are in its possession, and that the values set against each of these represent the actual cost to the company. The liabilities will also require a most careful examination at his hands with a view to determine that no liability has been omitted or under-stated. It need hardly be pointed out that no examination of a Balance Sheet, however critical and thorough it may be, can be said to be complete unless it is preceded by an exhaustive verification of all the items in the Profit and Loss Account of the period under audit, as already detailed in Chapter III.

As the question of verification of assets and liabilities entails a lengthy discussion of all the Balance Sheet items, it has been thought necessary to devote the following full Chapter towards it.

CHAPTER VI

VERIFICATION OF ASSETS AND LIABILITIES IN A COMPANY BALANCE SHEET

(With special reference to the Form F of Balance Sheet, under the Indian Companies Act, 1913-1936)

For the purpose of this Chapter, it will be assumed that the detailed checking of the books has been completed, that all points arising in connection therewith have been carefully noted and enquired into, and that a complete Trial Balance and Draft Final Accounts are before the auditor. It will further be assumed that the auditor has most minutely scrutinised the items composing the Profit and Loss Account, as fully explained in Chapter III, and has thoroughly satisfied himself that it reflects the true working results of the period under review.

It need hardly be pointed out that, in a Limited Company, the net profit shown by the Profit and Loss Account is transferred to the Profit and Loss Appropriation Account, and as the balance on this latter account appears on the liabilities side of the Balance Sheet, the Balance Sheet and the Profit and Loss Account are both closely inter-related to each other. It follows, therefore, that if any item of expense or income is omitted or is over or under-stated, or is wrongly adjusted, it will not only affect the accuracy of the Profit and Loss Account but will equally affect the correctness of the Balance Sheet. Similarly, any over or under-statement of assets or liabilities, or over or under-depreciation of assets will co-extensively affect the accuracy of both the Balance Sheet as well as the Profit and Loss Account. The scrutiny of the Profit and Loss Account should therefore receive as much attention, care and caution at the hands of the auditor as in the case of verification of the Balance Sheet.

VERIFICATION OF PROFIT AND LOSS ACCOUNT

For a satisfactory verification of the Profit and Loss Account, the auditor will have to make thorough enquiries into the following:—

- (1) That the requirements of the I. C. Act in regard to some items to be specifically shown therein have been duly complied with;
- (2) That all expenses have been duly authenticated and are well within the scope of the company's business, and that all items of expenses and gains have been shown under their appropriate heads;
- (3) That the several adjustments in respect of Outstanding Liabilities for expenses due and not paid, income received in advance or earned and not received, expenses prepaid, reserve for doubtful debts, depreciation, etc., have been properly made;

INDIAN COMPANIES ACT, 1913, AMENDED

Balance Sheet as at

CAPITAL AND LIABILITIES.				
CAPITAL—				
Authorised Capital....shares of Rs.....each ..	...	....	...	...
<i>(Distinguishing between the various classes of Capital.)</i>				
Issued Capital....shares of Rs.....each ..				
(i) <i>Shares issued as fully paid up pursuant to any contract without payments being received in cash....shares of Rs.....each.</i>	...	....	...	...
(ii) <i>Shares issued for payments in cash shares of Rs.....each.</i>	...	....	...	...
Subscribed Capital....shares of Rs.....each ..				
• Amount called up at Rs.....per share ..	...	....	...	...
Less—Calls unpaid—				
(i) <i>due from Managing Agents</i> Rs.....	...	....	...	....
(ii) <i>due from others</i> .. " .....	...	....	...	....
Add—Forfeited shares (amount paid up).			...	....
<i>Note.—Where circumstances permit, issued and subscribed capital and amount called up may be shown as one item, e.g.,</i>				
Issued and Subscribed Capital.....shares of Rs.....each, Rs.....paid up.	...	....	...	....
RESERVES .. .. .			..	....
DEBENTURES <i>stating the nature of security</i> ..			...	....
ANY SINKING FUND .. .. .			...	....
ANY OTHER FUND CREATED OUT OF NET PROFITS, <i>including any development fund</i> ..			...	....
ANY PENSION OR INSURANCE FUND .. .. .			...	....
PROVISION FOR BAD AND DOUBTFUL DEBTS ..			...	....
LOANS—				
(a) Secured—			...	....
(i) <i>loans on mortgages or fixed assets</i> ..	...	....	...	....
(ii) <i>loans on debentures</i> .. .. .	...	....	...	....
(iii) <i>loans from banks, stating the nature of security</i> .. .. .	...	....	...	....

TO 1936, SCHEDULE III FORM F

.....LIMITED

.....19

PROPERTY AND ASSETS.

FIXED CAPITAL EXPENDITURE—

(Distinguishing as far as possible between expenditure upon goodwill, land, buildings, leaseholds, railway sidings, plant, machinery, furniture, development of property, patents, trade marks and designs, interest paid out of Capital during construction, etc., and stating in every case the original cost and the additions thereto and deductions therefrom during the year, and the total Depreciation written off under each head. Where sums have been written off on a reduction of capital or a revaluation of assets, every balance sheet after the first balance sheet subsequent to the reduction or revaluation shall show the reduced figures, with the date of and the amount of the reduction made.)

... ..

PRELIMINARY EXPENSES

... ..

COMMISSION OR BROKERAGE

... ..

(Commission or Brokerage paid for underwriting or placing or subscribing shares or debentures until written off.)

Discount Allowed on the issue of shares or so much as has not been written off at the date of the balance sheet.

... ..

STORES AND SPARE Parts

... ..

LOOSE TOOLS

... ..

LIVE-STOCK AND Vehicles

... ..

STOCK-IN-TRADE

... ..

(Stating mode of valuation, e.g., cost or market value.)

BILLS OF EXCHANGE

... ..

BOOK DEBTS (other than bad and doubtful debts of a Bank for which provision has been made to the satisfaction of the auditors) ..

... ..

(Distinguishing between those considered good and in respect of which the company is fully

INDIAN COMPANIES ACT, 1913, AMENDED

Balance Sheet as at

CAPITAL AND LIABILITIES—Contd.								
(iv) liabilities to subsidiary companies	..	..	..	...	...
(v) other secured loans stating the nature of security	..	..	..	...	...
(vi) interest accrued on mortgages, debentures or other secured loans	..	..	..	...	...
(b) Unsecured—								
(i) loans from banks	..	..	..	...	...			...
(ii) fixed deposits	..	..	..	...	...			...
(iii) short-term loans	..	..	..	...	...			...
(iv) advances by directors or managers and managing agents	..	..	..	...	...			...
(v) interest accruing but not due and interest accrued and due	..	..	..	...	...			...
(vi) liabilities to subsidiary companies	..	..	..	...	...			...
UNCLAIMED DIVIDENDS	..	..	..					...
LIABILITIES—								...
For Goods supplied	..	..	..	...	...			...
For Expenses	..	..	..	...	...			...
For Acceptances	..	..	..	...	...			...
For Other Finance	..	..	..	...	...			...
ADVANCE PAYMENTS AND UNEXPIRED DISCOUNTS	..	..	..					...
(For the portion for which value has still to be given, e.g., in the case of the following classes of companies—Newspaper, Fire Insurance, Theatre, Club, Banking, Steamship Companies, etc.)								...
PROFIT AND LOSS	..	..	..					...
								...
								...
CONTINGENT LIABILITIES—								...
Claims against the company not acknowledged as debts	..	..	..	...	...			...
Money for which the company is contingently liable	..	..	..	...	...			...
(Showing separately the amount of any guarantees given by the company on behalf of directors or officers of the company.)								...
Arrears of Cumulative Preference Dividends	..	..	..	...	...			...

The information required to be given under any of the items or sub-furnished in a separate Schedule or Schedules to be attached to and to form

TO 1936, SCHEDULE III FORM F —Contd

.....19

PROPERTY AND ASSETS—Contd.

secured and those considered good for which the company holds no security other than the debtors' personal security, and distinguishing between debts considered good and debts considered doubtful or bad. Debts due by directors or other officers of the company or any of them either severally or jointly with any other persons to be separately stated.)

ADVANCES

(Recoverable in cash or in kind or for value to be received, e.g., Rates, Taxes, Insurance, etc., showing separately)—

- (i) loans given to subsidiary companies ..
- (ii) loans including temporary advances made at any time during the year to directors or managers of the company ..

INVESTMENTS

[Showing nature of investments and mode of valuation, e.g., Cost or Market Value and distinguishing—

- (i) investments in Government or trust securities ..
- (ii) investments in shares, debentures or bonds (showing separately shares fully paid up and partly paid up) ..
- (iii) investments in shares, debentures or bonds of subsidiary companies ..
- (iv) immovable properties] ..

INTEREST ACCRUED ON INVESTMENTS

CASH AND OTHER BALANCES

Amount in hand

Balances with Agents and Bankers (in detail showing whether on deposit or current account, etc.)

PROFIT AND LOSS

Rs.

items in this Form if not included in the Balance Sheet itself shall be part of the Balance Sheet.

(4) That any item of income extraneous to the usual course of the company's business or any capital gain brought into credit is shown under its distinct heading and not merged or mixed up with other items so as to give a misleading impression as to the trading results;

(5) That the distinction between capital and revenue has been rigidly maintained;

(6) That no unearned profit has been brought into credit; and

(7) That all losses, accrued as well as anticipated and relating to the period have been brought into account.

VERIFICATION OF ASSETS AND LIABILITIES

The auditor now enters upon a very important phase of the audit, namely, the verification of assets and liabilities. This is indeed one of the most vital points in an audit, for, should an auditor fail to perform his duty in this respect, falsification of Balance Sheet by way of inflation of profits, misappropriation or over-statement of assets, or omission or under-statement of liabilities would be left undetected by him. His duty in verifying the assets is two-fold. He must satisfy himself that they really existed at the date of the Balance Sheet and were free from any charge, and that they have been properly valued. In verifying the liabilities, he has to see that all liabilities have been inserted at their proper figures and that no liability has been omitted.

THE FORM F OF BALANCE SHEET

The Indian Companies (Amending) Act, 1936, has made substantial improvements regarding information to be conveyed to the shareholders and others to enable them to ascertain the true state of affairs of a company. Thus, in the matter of accounts, apart from the compulsory compilation of a Profit and Loss Account, the New Form F, representing the prescribed Form of Balance Sheet, provides for more detailed disclosures being made in the Balance Sheet so as to help any one reading it to judge fairly and accurately the exact financial condition of the company. The Form appears on pages 148-151, and all additional information required under the AMENDED FORM is shown in italics so that the improvements made on the Old Form may be seen at a glance. The student will do well to study this Form carefully with a view to grasp the grouping and classification of the Assets and Liabilities, and also to bear in mind the specific information required to be given in respect of each asset or liability.

The following important points need to be carefully noted in connection with Form F of Balance Sheet:—

PROPERTY AND ASSETS SIDE

It would be noticed from this Form that the Assets and Liabilities are arranged in ORDER OF PERMANENCE, the Fixed Assets being shown above the Floating Assets and the Fixed Liabilities over the Floating Liabilities.

FIXED CAPITAL EXPENDITURE

The Fixed Capital Expenditure is required to be distinguished as far as possible between the several assets required, such as Goodwill, Land, Buildings, Leaseholds, Railway Sidings, Development of Property, Plant, Machinery, Furniture, Patents, Trade Marks, Designs, etc.

Each Fixed Asset will have to be shown at its ORIGINAL COST and under its APPROPRIATE HEADING. Any ADDITIONS thereto or DEDUCTIONS therefrom during the year will have to be clearly indicated. The TOTAL DEPRECIATION written off under each head will also have to be shown by way of deduction from the asset in question.

Where any assets have been written down on a REDUCTION OF CAPITAL or on a REVALUATION, every subsequent Balance Sheet will have to disclose the date of such reduction and the amount of the reduction made.

INTEREST PAID OUT OF CAPITAL DURING CONSTRUCTION

Where any interest has been paid out of capital during construction, such amount is allowed to be capitalised and must be shown distinctly on the assets side. The Balance Sheet must also show the Share Capital on which, and the rate at which, interest has been paid out of capital.

PRELIMINARY EXPENSES, UNDERWRITING COMMISSION OR BROKERAGE ON SHARES OR DEBENTURES, AND DISCOUNT ON ISSUE OF SHARES OR DEBENTURES

Such items are required to be shown under their distinct heads until written off. It may be mentioned in connection with these items that inasmuch as they are of the nature of deferred revenue expenditure and do not represent any tangible assets, it would seem desirable and sound not to permanently capitalise them, but to write them off as soon as circumstances would permit.

STOCK-IN-TRADE

The mode of valuation, i.e., cost price or market value will have to be clearly stated on the face of the Balance Sheet.

BOOK DEBTS

These will have to be distinguished between good, doubtful or bad; further, debts fully secured and unsecured will have to be separately stated. Debts due by Directors or other officers of the company will also have to be specifically disclosed.

ADVANCES

Under this head will appear pre-paid expenses by way of Rates, Taxes, Insurance, etc., as also LOANS, if any, given to SUBSIDIARY COMPANIES, under distinct heads.

Any loans, even by way of temporary advances, if made to Directors or Managers, at any time during the year, will have to be disclosed. Even where such a loan has been repaid before the end of the financial period, the fact will have to be stated by way of a note.

INVESTMENTS

The mode of valuation of Investments, viz., cost or market value, must be clearly mentioned. Further, the different classes of investments must be shown under separate headings as under:—

- (a) Investments in Government or Trust Securities,
- (b) Investments in shares, debentures or bonds (showing separately shares fully paid up and partly paid up),
- (c) Investments in shares, debentures or bonds of subsidiary companies, and
- (d) Immovable properties.

INTEREST ACCRUED ON INVESTMENTS

Under this head, any interest on investments calculated from the date upto which it was last received to the date of the Balance Sheet will have to be brought in.

BANK BALANCES

While showing the BANK BALANCES, it must be stated whether they are on Current or Fixed Deposit Accounts.

PROFIT AND LOSS ACCOUNT

The Loss, if any, made by a Limited Company will remain on the debit of Profit and Loss Account and will appear as the last item on the assets side, under the heading of Profit and Loss Account.

CAPITAL AND LIABILITIES SIDE

AUTHORIZED CAPITAL

The different classes of the authorised share capital are required to be distinguished, under this head.

ISSUED CAPITAL

The issue of shares in cash and the issue for consideration other than cash must be separately stated.

UNPAID CALLS

Calls unpaid and due from managing agents are required to be shown separately from those due from others. It may be noted that, although not so specifically mentioned in the Form, calls unpaid by directors will also have to be separately stated.

FORFEITED SHARES

The amount received on Forfeited Shares is required to be shown distinctly from the Paid-up Capital.

REDEEMABLE PREFERENCE SHARES

Where such shares are issued, the Balance Sheet must state the date on or before which the shares are liable to be redeemed.

RESERVES

Under this head will be shown such Reserves as may have been built up by way of appropriations out of undistributed profits, such as Reserve Fund, Dividend Equalisation Fund, etc.

Any provision, if made, for decline in market value of securities and styled either Investment Depreciation Fund or Investment Fluctuation Fund may preferably be shown as a deduction from the asset in question.

PROVISION FOR BAD AND DOUBTFUL DEBTS

This item, although required to be shown on the liabilities side of the Balance Sheet, would be more correctly shown as a deduction from the item Book Debts on the assets side.

DEBENTURES

When these are secured, the nature of the security should be stated.

SINKING FUND

Debenture Redemption Fund, or Sinking Fund for the redemption of Leasehold, if any, would appear under this head.

SECURED LOANS

These are required to be classified as under:—

- (a) loans on mortgages or fixed assets,
- (b) loans on debentures,
- (c) loans from banks, stating the nature of security,
- (d) liability to subsidiary companies,
- (e) other secured loans, stating the nature of security, and
- (f) interest accrued on mortgages, debentures or other secured loans.

NOTE.—As the liability on account of Debentures is shown as a separate item, it is assumed that Loans on Debentures appearing as item (b) would mean Loans on the collateral security of debentures.

UNSECURED LOANS

These have also to be classified as under:—

- (a) loans from banks,

- (b) fixed deposits,
- (c) short-term loans,
- (d) advances by directors or managers and managing agents,
- (e) interest accruing but not due and interest accrued and due, and
- (f) liabilities to subsidiary companies.

PROFIT AND LOSS ACCOUNT

The details of appropriation of profits are omitted, as a separate Profit and Loss Account is now made compulsory.

CONTINGENT LIABILITIES

Along with other Contingent Liabilities, the amount of any guarantees given by the company on behalf of directors or officers is required to be separately shown under this head.

Before we proceed to deal with the methods of verification of some of the usual assets found in a Company Balance Sheet, it is deemed necessary to discuss the basis of valuation of fixed and floating assets of a company.

VALUATION OF ASSETS

There appears to be some misconception in the lay mind regarding the meaning to be attached to the figures in a Balance Sheet. The opinion is held by some that if the assets of a company would not realise the values stated in the Balance Sheet in the event of liquidation, such Balance Sheet is unreliable and that the auditor has failed in his duty. The true value of an asset does not necessarily mean the amount that an asset, if offered for sale by auction or otherwise, would realise. That would be difficult to arrive at, in almost all cases. What is aimed at in drawing up a Balance Sheet is a fair estimate of the value of the assets of a company as a going concern. A company's Balance Sheet is not drawn for the purpose of showing what the capital would be worth if the assets were realised and the liabilities paid off, but rather to show how the capital stands invested. If the values shown are based on principles generally recognised as sound and correct, and if the basis of valuation is clearly indicated on the Balance Sheet, then such Balance Sheet is "properly drawn up so as to exhibit a true and correct view of the state of the company's affairs" as required by the Act.

Ordinarily, Fixed Assets which are held not with a view to re-sale but which have been acquired by a company by way of permanent equipment to enable the company to earn profits for a number of years by their use, are valued at original cost less an estimated amount of deterioration such assets are deemed to have undergone in each year owing to the use made thereof.

On the other hand, Floating Assets which are produced or acquired by a company in course of its business and are held with a view to re-sale or immediate realisation into cash should always be valued on the basis of either cost or market price whichever is lower at the date of the Balance Sheet.

In other words, whereas fixed or permanent assets are unaffected by market fluctuations and are always valued on the standpoint of their utility to the concern owning them, the values of floating or circulating assets are always modified by market fluctuations for the reason that, as it is the intention of the company to convert these assets into cash, they should not be assessed in the Balance Sheet at anything more than they are likely to realise, even though they may have cost more.

It must be remembered, however, that an auditor is not a valuer. The company's directors and managers are always supposed to be the most competent persons to make a valuation, and the auditor can only accept the same after proper enquiries and research. What the auditor has to do is to obtain all the information available, and, in the light of the facts of which he has knowledge, critically examine the figures, test their probability and consistency, ascertain that the basis of valuation is correct, and so form his own opinion as to the accuracy of the statement.

If the auditor is dissatisfied with the mode of valuation or the figure set against any particular asset, he should have the courage of his convictions and report the fact to the shareholders. The risk of offending the directors and even losing the audit should not weigh with him in coming to a decision, and once he has decided to report, he should do so in a clear-cut language and not try to protect himself by the use of cunning phraseology in his report.

We now proceed to deal with the methods of verification of some of the usual assets found in a Company Balance Sheet, taking them in the order as set out in the prescribed Form.

GOODWILL IN JOINT-STOCK COMPANIES

Although Goodwill exists in every prosperous undertaking expected to yield future super-profits, it is recorded in the books of a Company and made to take a visible shape only when it is acquired for a valuable consideration and when it thus results in a practical financial transaction.

Once Goodwill is brought into record, it is classed as a fixed asset, and it is not necessary to value it at its realisable price at each balancing period for Balance Sheet purposes. Evidently, therefore, there is no necessity to bring into account the temporary fluctuations in its value arising from any increase or decrease in the average profits of the Company. But the fact that needs to be emphasised is that super-profits can never be expected to arise in perpetuity in any business, as a result of ordinary trade competition. It is a matter of common knowledge that capitalists are always on the look-out for an extra-profitable opening for the employment of their capital, and the fact that there are super-profits in any particular business will soon prompt them to set up rival and competing businesses. There will also be the chance of the products dealt in losing in popularity and public demand due to change of taste or fashion, or it is probable that new inventions may supersede the

use of any existing patented articles. No Goodwill can, therefore, ever be considered as eternal, and it is a fallacy to treat purchased Goodwill as representing a permanent value.

It would thus seem advisable to provide against its probable shrinkage in value from out of surplus profits, in times of prosperity. But the provision in this respect should not fall on the Profit and Loss Account as that would tend to obscure the actual trading results of the undertaking, but must come as a charge on the Profit and Loss Appropriation Account by means of an allocation of divisible profits. Whereas the extinction of Goodwill from the books of account will in no way affect its actual value in a profitable concern, such a course will ensure the entire capital of the company being represented by tangible assets and will serve to strengthen the financial condition of the company by the retention of a portion of the legally divisible profits and the consequent increase of working capital. Even when it is thought desirable to diminish the book value of goodwill gradually, the best method of dealing with the item will be not to wipe it off absolutely from the books, but to retain it in the Balance Sheet at its original cost and to credit the provision made for its reduction or elimination to a separate redemption fund. It need only be pointed out that however prudent, expedient and commendable such a practice may be from the view-point of finance, there is no legal obligation on a company to provide for the decline in value of its goodwill before declaring a dividend.

A Joint-Stock Company formed with the object of taking over an established business and which issues a Prospectus inviting subscriptions for its shares or debentures must state the amount of purchase-money which is being paid for Goodwill. Besides, in the prescribed form of Balance Sheet under the Indian Companies Act, the item of purchased Goodwill, if any, is required to be shown distinctly amongst the Fixed Assets of the Company.

When a Joint-Stock Company takes over a running business, and the value of Goodwill has not been fixed specifically, the difference between the total purchase-consideration and the assets at the agreed valuation less any liabilities taken over from the vendors will represent the price for Goodwill. The auditor should see the agreement with the Vendors in order to ascertain that Goodwill has been brought in the books at a proper figure. The item should be shown at cost less any amounts written off, and the basis of valuation must be clearly indicated on the Balance Sheet.

If a Company issues its shares at a premium, such premium can well be applied towards the reduction or elimination of Goodwill from the books. This process is sometimes objected to on the ground that the Balance Sheet fails to set out the fact of the Company having received premium on shares. Such an objection can, however, be overcome by showing the amount of premium on shares in the inner column on the liabilities side of the Balance Sheet with a note underneath that the amount has been applied towards the reduction or elimination of Goodwill, as the case may be.

There are occasions when a Company expends an abnormally heavy amount with the object of CREATING A GOODWILL. Thus, heavy expenditure may be incurred in experiments which may ultimately result in the securing of a patent and a consequent monopolised business, or abnormal amounts may be expended on introducing a new invention or product in the market, or an enormous amount of loss may be suffered by a newspaper concern in its initial stages. If those in management seek to capitalise such expenses or losses under the heading of Advertising Goodwill on the argument that they helped towards the success of the concern, the auditor should see that reasonable grounds exist for attributing any such value to Goodwill and that the item is plainly stated in the Balance Sheet under its distinct heading and in a manner so as not to be mistaken for purchased goodwill; but inasmuch as such an expenditure cannot be treated as a permanent capital asset, the auditor would do well to see to its being written off over a reasonable period of years.

Lastly, the auditor should see that no improper items are ever debited to Goodwill Account, and in no case is the value of goodwill written up. He may give his opinion, if specifically asked to do so, but he cannot insist upon this item being written down out of profits, unless the Company's own Articles provide for such a procedure.

FREEHOLD PROPERTY

The auditor should examine the title deeds and see that the property is in the name of the company. If the property has been mortgaged, a letter or certificate should be obtained from the mortgagee to state that he holds the title deeds, and mentioning the amount of the debt created. He should ascertain on enquiry from his client that there is no second mortgage on the same property. He should see that proper depreciation has been written off in respect of wear and tear of buildings, and that all repairs and renewals are charged to revenue. Any addition to the value during the current year must be carefully vouched and scrutinised to see that it represents actual addition or extension to the property. The item must be stated in the Balance Sheet at original cost, and the total depreciation written off to date should be shown as a deduction therefrom. Any additions made during the year should be clearly specified. It is never desirable to write up the book value of this asset until realisation, although it may have actually increased in value. Where, however, if any such appreciation is brought into the books, the auditor should see that the corresponding credit is given to a capital reserve, and the amount thus added to the original cost must be separately stated on the Balance Sheet.

The auditor should verify the purchase price from the statement of purchase received from the client's solicitors. All legal charges in connection with the conveyance are allowed to be capitalised. Where there is any doubt as to the Title Deed being in order, the auditor should consult the client's solicitors.

LEASEHOLD PROPERTY

The lease should be seen in order to ascertain the cost and the term. All repairs must be charged to revenue, only actual additions or extensions being allowed to be capitalised. But the original cost as also the additional capital amount expended must be spread over the term of the lease so as to extinguish the asset at the expiration of the lease. Whilst considering the amount of depreciation to be written off the lease, the question of the amount to be provided for dilapidations at the end of the term should also be borne in mind. The original cost must be shown in the Balance Sheet and the provision for depreciation should be deducted therefrom. The Articles of the Company must be seen to ascertain if any provision for redemption of the lease is to be made prior to distribution of profits. The auditor should also ascertain that all the conditions of the lease are being duly carried out.

PLANT AND MACHINERY

This asset must also be shown at its original cost with the provision for depreciation as a deduction. The original acquisition would be verified with the corresponding Invoices or the agreement with the Vendors. All additions during the year must be vouched by the auditor as being represented by actual additions or improvements and must be shown distinctly. If possible, the auditor should obtain proper schedules of plant and machinery prepared and signed by the engineer-in-charge. Repairs and renewals should always be charged to revenue. The question of depreciation must receive the auditor's most careful attention. The provision should be such as to reduce the book value of the plant to its residual value at the end of its estimated life. The depreciation may be calculated in any one of the various ways, but it must be seen that the same method is utilised, year after year. If the plant is of a heavy nature, which will be required to be renewed in full at the end of a lengthy period, the Depreciation Fund System should be adopted. In large undertakings, where the machinery is very costly, the amount of depreciation would make a material difference in the net profit. In such cases, a Machinery Register is kept in which separate accounts are opened of the different sections of machinery requiring different rates of depreciation. As the rates of depreciation vary according to the durability and class of the machinery and the use it is subjected to in each particular business, it is necessary that these should be fixed by the chief engineer or some responsible person.

In writing off depreciation, no regard need be taken of any fluctuation in the market price of similar plant, whether such price be up or down, as the plant is held as a fixed asset and not for the purpose of re-sale.

In case of sale of any old machine or part thereof, care must be taken to see that the item is not credited to sales but to Plant and Machinery Account, and that any difference between the book value and the realised

price is written off. The cost price of any machine sold must be shown as a deduction from the total original cost of Plant and Machinery.

It must be borne in mind that it is the duty of the directors, and not the auditor, to fix the rate at which the depreciation of fixed assets is to be calculated. Should the auditor having represented his views to the directors, be of opinion that the amount of depreciation finally decided upon by them is inadequate, he must unhesitatingly state that opinion to the shareholders in his report.

Where any costly plant is located abroad, the auditor should secure a report from the local engineer as to its working efficiency and the adequacy of provision in respect of depreciation.

While scrutinizing the additions to Plant during the period under audit, the auditor should particularly make sure that items of repairs or replacements are not wrongly capitalised. Where the additional plant has been manufactured by the client's own staff, he should see that wages, material, direct charges and oncost burden applicable thereto have been arrived at on proper basis. He should obtain a certificate from the chief engineer as to the cost of such plant.

PATENTS

A list giving the description of each patent, the registered number, date and number of years to run should be furnished to the auditor. The certificate of grant of patent or the assignment of the interest in it should be seen, and the cost and any subsequent expenditure on further protection should be verified. Renewal fees should be charged to revenue. The cost of a patent should be written off in the course of its life. The auditor should see that this is being done.

It may be, that a patent might become valueless due to obsolescence or failure to create a demand of the patented article, and in such a case, the auditor should see that its value is written off even before the expiration of the period covered by the Patent.

In a business where patents form valuable assets, periodical revaluation becomes necessary. It is not desirable, however, to write up the value of any patent, even if on a revaluation it is found to be in excess of the book value.

COPYRIGHTS

The verification of an item under this heading in a Balance Sheet will be on lines similar to those just described in the case of patents. The best method of dealing with copyrights is to revalue these at the end of each financial period. Where any publication ceases to command sales, the copyright in respect thereof loses its value, and the cost of publication of such work should, therefore, be written off as a loss.

PATTERNS AND DRAWINGS

Where the intrinsic value of Patterns and Drawings is comparatively small, it is advisable that the cost of these should be treated as a revenue charge. Where, however, a considerable amount has been expended thereon, and an exceptional value attaches to such Patterns and Drawings because of the use to which they are likely to be put, they may be temporarily capitalised. In any case, they are assets with little residual value and they quickly wear out. Consequently, the rate of depreciation to be applied to them should be a heavy one, and the cost should be extinguished in any case from within 3 to 5 years. If they are not likely to be used for more than a single season, the whole cost should be charged against the current year's revenue.

The auditor should satisfy himself as to their existence by having a duly certified inventory produced to him, and should see that an adequate provision has been made for the loss in value by depreciation.

MOTOR LORRIES AND VANS

The original cost of these is appreciably high in some businesses, and as such assets are liable to heavy wear and tear, the auditor should ensure that the rate of annual depreciation applied is adequate. All additions during the year should be carefully scrutinized to ascertain that only actual additions by way of new acquisitions are capitalised, and that repairs and replacements have been charged off to revenue.

UNCOMPLETED CONTRACTS AND WORK-IN-PROGRESS

The auditor should ascertain after thorough enquiry that all work-in-progress in manufacturing concerns and uncompleted contracts in case of builders, constructional engineers, ship-builders and public works contractors are not valued beyond actual cost. The cost in such cases would be represented by amounts actually expended by way of direct material, labour and charges, and a reasonable percentage in respect of direct or works oncost. In very rare cases, a percentage is added also in respect of administration oncost. The auditor should obtain a certificate from the chief engineer that such valuations have been based on fair and consistent basis.

FURNITURE AND FIXTURES

All original purchase should be verified with the invoices received from the dealers. This asset should be depreciated in just the same manner like the Plant and Machinery, having due regard to its probable life. As fixtures and fittings of the nature of shelves, partitions, electric fans, fittings, etc., have very little break-up value, a higher percentage of depreciation should always be provided for these than other assets of a more tangible nature such as, office desks, tables, chairs, safes, etc. If any fresh amount is added to such an asset account during the period under audit, the auditor must scrutinise the item to see that it represents some fresh asset acquired, and

not a revenue charge by way of repairs or renewals wrongly capitalised. All additions or deductions during the year should be shown on the face of the Balance Sheet.

ASSETS ACQUIRED ON HIRE-PURCHASE OR INSTALMENT AGREEMENT

Where assets have been acquired on Hire-Purchase or Instalment Agreement, the auditor should see that in no case is the asset account charged with anything beyond its cash purchase price. Further, he should ascertain that the interest attributable to each year is duly brought into that year's accounts. In regard to depreciation, the same should be calculated on the full cash price of the asset in question from the first year of acquisition. The Hire-Purchase or the Instalment Agreement should be inspected in order to ascertain the terms and conditions of purchase. In case of Hire-Purchase Agreement, only the instalments paid from year to year need be brought into account. If the full cash price is brought into record from the first year, and shown as an asset, then the unpaid instalments should be shown as a liability or deducted from the asset. It should be seen that all instalments to date of Balance Sheet have been paid.

INTEREST PAID OUT OF CAPITAL DURING CONSTRUCTION

Section 107 of the Indian Companies Act allows of interest being paid on the share capital of a company during the construction of its works, provided that such company is authorised to do so by its Articles or by special resolution, that previous sanction of the Local Government has been obtained, that the rate of interest does not exceed 4%, and that such payment is not made beyond the period as is determined by the Local Government.

The amount of interest thus paid is allowed to be capitalised and may be added subsequently to the cost of construction of the works or plant as the case may be.

Under the Form F, the item of interest, if any, paid out of capital during construction, is required to be separately shown on the assets side of the Balance Sheet. The Balance Sheet must also indicate the share capital on which and the rate at which such interest has been paid during each period. Where such interest is paid, the auditor should see that all the requirements of the Act, in this connection, have been duly complied with.

PRELIMINARY EXPENSES AND COMMISSION ON SHARES

Although these items appear on the assets side of the Balance Sheet, they are in reality items of revenue expenditure which are for the time being "held up." The items have already been discussed in the previous Chapter. The Form F allows these to be shown on the assets side of the Balance Sheet until written off, but as they do not represent any tangible values, the earlier they are written off the better.

LOOSE TOOLS

It is usual to have a valuation made of these at each stock-taking, the schedules being properly certified by some responsible manager. The difference between the actual value as ascertained from the inventory and the book value must be written off as depreciation. Where the undertaking manufactures its own tools, the auditor should see that the cost of these is properly ascertained, and should verify the same with the Cost Sheets certified by the chief engineer.

LIVE STOCK

This should be scheduled and certified by a responsible official, and brought into each Balance Sheet at a fresh valuation.

STOCK-IN-TRADE

As the correctness of the profit of a business depends to a great extent on the accuracy of the valuation placed on the closing stock, it will be readily appreciated that the verification of this asset forms one of the most important parts of an auditor's duty. There is, however, a great divergence of opinion within the ranks of the profession on this subject. On the one hand, it is submitted that if the auditor accepts, without inquiry, the figures on which are based the results of the trading, his certificate of such results is useless. As a trained expert in the general intricacies of commerce, acquainted with the details of the concern under audit and with his right of access to all books of account, documents and vouchers, and to ask for all information and explanations which he may require, an auditor ought to be able to ascertain and satisfy himself as to the accuracy of the stock values placed before him. On the other hand, however, it is contended that an auditor is not a valuer, and in ordinary circumstances, he can rely on the certificate of the manager, and he cannot do anything more than apply certain tests to satisfy himself as to the correctness of the stock values.

There can be no question as to this fact that a more exhaustive examination of this item would materially increase the efficiency of an audit, but it is a matter of some practical difficulty to suggest how this can be accomplished. If it were made compulsory for companies to keep proper Stock Accounts, then the verification of stock at end would be considerably facilitated. In the absence of stock accounts, there is no means by which an auditor can even approximately verify the stock-taking inventory, although, of course, in exceptional cases, a mere scrutiny of the figures may convince him that there is something radically wrong.

The following are the usual tests by which an auditor may satisfy himself as to the correctness of the Stock-in-trade to some extent:—

- (1) Ascertain the method of stock-taking and the basis of valuation.
- (2) See that the Stock Sheets have been subjected to a good internal

check, e.g., they are certified as to take, prices, extensions and additions and generally approved as correct by the managing director.

(3) Check calculations and additions.

(4) Check a few of the important items with actual invoices as to prices.

(5) Examine some of the quantities in Stock Sheets with those as shown by the Stock Books, if such be kept.

(6) Ascertain that the stock is valued on the same basis as in the previous year.

(7) Ascertain that obsolete and unsaleable stock is written down.

(8) Compare the percentage of gross profit on turn-over with that of the previous period and enquire into the cause of any violent fluctuation.

(9) See that the goods entered as sold and not delivered are not included.

(10) See that the goods bought and not entered in the Invoice Book are not included.

(11) Ascertain that the unsold balances of goods sent out on consignment, on sale or return, or with branches are not included at selling price.

(12) Ascertain that the value of unfinished goods is taken at actual cost. In case of unfinished goods, the basis of valuation will be the cost of the materials consumed and the wages spent thereon to the date of the Balance Sheet, and to this, sometimes, is added a percentage to cover factory oncost, such as foreman's wages, fuel, power, lighting, heating, depreciation of plant, etc. In case of finished goods, a reasonable percentage in respect of office oncost will also be allowed to be added to the works cost.

Further than this the auditor cannot go, and it is not desirable that he should be expected to do so. It is always desirable to show on the face of the Balance Sheet by whom the stock has been certified.

In no event should stock be valued at higher than cost, as the effect will be to take into account a purely fictitious and unrealised profit. If, however, the market price is lower than the cost, the stock should be valued at market price.

An exception to the above general rule in regard to stock valuation is to be found in the case of Wine and Timber Trades where the stocks appreciate in value from year to year due to their maturing in quality. In such a circumstance, it is permissible to add a reasonable percentage to the original cost at periodical intervals to cover the burden in respect of interest on the portion of capital thus locked up. In no case, however, should such value exceed the then market values of similar class of goods.

Heads of departments, or managers of branches, should be made responsible for their individual stock-taking, and should be asked to sign their Stock Sheets, certifying the same as correct.

If the auditor is, with good reason, dissatisfied with the value placed upon this item, he should qualify his report to the shareholders accordingly. Provided he does this, and has exercised reasonable care, he need not feel weighed down with any very great responsibility.

The PRESCRIBED FORM of Balance Sheet requires that the MODE OF VALUATION of stock must be clearly stated.

STOCK OF GOODS ON CONSIGNMENT

If at the date of the Balance Sheet a portion of the goods sent out on consignment has remained unsold, the auditor should carefully scrutinise the basis of valuation of such stock. It should be seen that such stock is not valued at anything beyond its cost price, and the cost price for this purpose would include the invoice price of the goods plus freight and all charges incurred by the consignors. Such unsold stock should be verified with the certificate received from the consignees. If from such certificate it appears that the goods have been damaged or depreciated in any way, a proper allowance should be made in this respect from the cost price of goods.

When goods are charged to the Consignment Account at *pro forma* invoice prices including a percentage above cost, the effect of such a procedure would be to take credit in the books for profit before it is realised, and the auditor should then see that the necessary adjustment is made in respect of consignment goods which remain unsold at the date of the Balance Sheet so that they may not be brought in at anything beyond the actual cost.

If there are any long-standing debit balances on Consignments or Consignees' Accounts, the auditor should most carefully scrutinise these to ensure that they are not doubtful or bad, otherwise, ample provision should be made for all likely bad debts.

STOCK OF GOODS SENT ON SALE OR RETURN

It may be found that transactions relating to goods sent on "sale or return" have been entered as ordinary credit sales in the books of the company. In such a circumstance, the auditor should require a schedule to be prepared of goods not approved of and lying in the hands of customers at the close of the financial period, and have an adjustment entry passed with the total amount thus ascertained, debiting the Sales Account and crediting Debtors in Suspense Account. The effect of this entry will be to bring down the Sales to their correct figure. The credit balance of Debtors in Suspense will be deducted from the total amount of Sundry Debtors with the result that the item Sundry Debtors will also be toned down to its proper figure. The stock of goods in the hands of customers should then be valued at cost, and shown on the credit side of the Trading Account and also as an asset in the Balance Sheet.

BILLS RECEIVABLE

The schedule of Bills in hand at the date of the Balance Sheet should be compared with the Bills Receivable Book. Bills on hand should be verified by actual inspection of the bills, care being taken to see that no overdue bills are included. If any bills have been met subsequent to the period but prior to the date of audit, the same should be traced through the Cash Book. If bills are lodged with bankers for collection, a certificate should be obtained from the bank stating the bills on hand at the date of the Balance Sheet. In regard to Bills that may have been discounted or endorsed away and remain unmatured at date of audit, the contingent liability in respect thereof should be noted at the foot of the Balance Sheet. A proper reserve should be made in regard to overdue bills.

BOOK DEBTS

Lists of all Open Accounts should be checked with the Ledger. The auditor should then go through the schedules of debtors with some responsible official to see that all bad debts are written off and that a sufficient reserve is made for doubtful debts and discounts. Items of large allowances and long credits to customers should be confirmed and initialled by some responsible official. In regard to debts already written off as bad, the auditor should see some documentary evidence in support thereof. It is always desirable to have the Bad Debts sanctioned by the Board of Directors and duly minuted. Particular attention should be directed to any big items of sales passed through at the close of the year with a view to ascertain that they are genuine. Enquiry should be made to see if the sales include transactions for future delivery. Goods on Consignment, Sale or Return, and goods sent to Branches should not be mixed with the debtors, but must be valued at cost price or under and included in the stock or shown separately.

Statute-barred debts and debts under dispute should be reserved for in full. In large businesses, where the debtors' balances are numerous, the auditor should ask for a list of Bad and Doubtful Debts prepared and certified by the secretary, manager or some other responsible official.

The PRESCRIBED FORM of Balance Sheet requires debts considered good and debts considered doubtful to be distinguished. Debts due by the directors or other officers of the company either severally or jointly with any other persons should also be stated separately. In case of a Bank Balance Sheet, debts considered good and in respect of which the Bank holds no security other than the debtor's personal security, are further required to be shown separately from debts which are fully secured. The auditor should, therefore, see that these requirements under the Act are fully carried out.

An important change brought about by the Amending Act is in respect of a compulsory disclosure to be made by ALL COMPANIES in regard to Secured and Unsecured Debts.

DEBTORS FOR LOANS

If there are any debtors for loans granted by the company, the auditor should see that the amount of such loans is not included in the list of sundry debtors but is shown separately. Where such loans are secured, he should inspect the securities and obtain letters from the debtors acknowledging the amounts owing by them at the date of the Balance Sheet. Where the loans are unsecured, the auditor should enquire if the amount is recoverable in full.

Where loans are owing by directors or other officers of the company, it should be seen that a clear statement to that effect is made on the face of the Balance Sheet.

ADVANCES

Under this head, unexpired Rates, Taxes, Insurance, etc., are required to be shown. The amount appearing under this head must be vouched with the schedules giving full particulars of each item carried forward.

Loans to Subsidiary Companies should be shown separately.

INVESTMENTS

Where there are many investments, as in case of a Bank or an Insurance Company, complete schedules of such should be produced to the auditor, showing the names of the investments, the actual cost, and the market value at the date of the Balance Sheet. It is a prudent policy to write the investments down to market value, if that is the lower. If the total market value of the securities happens to be less than their total cost, it would be advisable to provide for such shrinkage in value by debiting Depreciation Account and crediting Investment Fluctuation Account. The former account would be charged to Profit and Loss Account, whereas the latter account will be shown as a deduction from the original cost of the Investments on the assets side of the Balance Sheet. Where such a fall in the market value at the date of the Balance Sheet appears to have been temporary, by the market having again resumed its normal level at the time of the audit, such temporary fluctuation need not be brought into account, but may be ignored. Where, however, the Investments are of a considerable amount, and they are taken at cost and no provision is made for the fall in market value, it is best to make a note on the Balance Sheet as to what the market value was.

It is important to note that the basis of valuation of Investments for Balance Sheet purposes will depend upon the object for which they are held. Thus, in case of a Trust Company where the object would be to hold the Investments as fixed assets and distribute the income arising therefrom among the shareholders, even a permanent fall in value need not necessarily be brought into account. This would of course be subject to the Memorandum and Articles of the Company. Where, however, the securities are held by Finance Companies as floating assets by way of temporary investments or for

the purpose of re-sale, their book value should always be written down to the market value, if the latter happens to be lower. A sound policy, in all cases, would be always to provide for the shrinkage in value from the profits before distribution.

Where Investments are acquired as a result of Underwriting Contract, the cost price would be the amount subscribed less the underwriting commission received.

Where the market value is in excess of the cost, it is never sound to bring such profit into account until the Investments are sold.

An important point for the auditor is to see that where a company holds gilt-edged securities as also shares or debentures in trading, industrial or mining concerns, the whole is not shown under the one heading of Investments, but is properly sub-divided as to convey a fair idea as to the nature of the investments on the face of the Balance Sheet. The classification of the investments as required by the New Form F, must receive the auditor's close attention.

The cost of the Investments should be verified with broker's bought notes. The securities for all the Investments should be examined by the auditor or certificates seen as to their location. Shares and ordinary stocks will be verified by the production of certificates, inscribed stocks by the usual certificates from the bank of inscription. Bonds to bearer should be examined, and it should be seen that coupons for the next interest payments are attached. The whole of the investments should be produced to the auditor at the same time, and must remain under his control until the inspection is completed.

When any securities have been sold between the date of the Balance Sheet and the date of examination of securities, the sold notes should be seen and the cash received should be traced through the Cash Book.

The Prescribed Form of Balance Sheet requires the mode of valuation to be indicated. Investments in Shares or Debentures of Subsidiaries must be separately stated.

INTEREST ACCRUED ON INVESTMENTS

The auditor should check the statement showing interest accrued from Investments held by the company to the date of the Balance Sheet and not received.

HOLDING AND SUBSIDIARY COMPANIES

The Amending Act inserts, for the first time, several provisions in regard to the disclosures to be made by Holding Companies in their Balance Sheets in relation to their dealings with their own Subsidiaries, and as a separate Chapter is devoted to these, the same have not been discussed here.

DEFERRED REVENUE EXPENDITURE

In case any amount is expended by way of abnormally heavy advertising, unusually heavy repairs or replacements or expenses on removal of business, there can be no objection to spreading such an expenditure over a term of years, provided the benefit to be derived from it is likely to last for such period. Such items come under the heading of Deferred Revenue Expenditure, and until the whole amount expended is written off, the debit balance will appear on the assets side of the Balance Sheet. Care must, however, be taken to see that they appear under a heading clearly indicating the nature of the expenditure so that no one reading the Balance Sheet may mistake them for any tangible assets.

The auditor should satisfy himself after carefully inquiring into the circumstances that the distribution of the expense over a term of years is reasonable and justifiable.

In this connection, it is important to note Section 17(2) which requires that "when any item of expenditure which may in fairness be distributed over several years has been incurred in any one year, the whole amount of such item shall be stated, with the addition of the reasons why only a portion of such expenditure is charged against the income of the year."

Recently, a practice seems to have been set on foot by newly registered companies to temporarily hold over a portion of the establishment and other expenses by charging the same to an account styled "Organization Expenses" or "Development Expenses." The account is then treated as Deferred Revenue Expenditure so that the whole amount may not be charged off to revenue in the year in which it has been expended, but may be distributed over a number of years. The argument held out by those in management is that such expenses were incurred over organizing the work at the Head Office, the branches or agencies of the company, and inasmuch as the benefit arising from the expenditure will be reaped by the future years, it would not be fair to burden the current year's income with the whole amount. Under such a circumstance, it would be the duty of the auditor to clearly specify the individual items which have been so held over and which make up the total Organization Expenses on the face of the Profit and Loss Account. Further, he should satisfy himself that only legitimate items directly connected with the organisation or development of the undertaking are included, and the proportion so carried over is reasonable. If he is not satisfied with the allocation, he must mention the fact specifically in his report.

CAPITALIZATION OF REVENUE EXPENDITURE

A practice also obtains amongst manufacturing concerns to capitalize the whole of the revenue expenditure incurred till the concern has reached a revenue-earning stage by distributing the same over the fixed assets on the basis of their respective costs. Such a practice is by no means commendable inasmuch as it unduly inflates the original cost of the fixed assets,

and the auditor, if asked, should never favour such a procedure. If, however, those responsible for the accounts insist on their own way of adjustment, the auditor should at least see that the additional amount charged to each asset in this manner is clearly indicated on the Balance Sheet. Rather than permanently capitalize expenditure which is revenue in its nature, a better plan would be to treat the amount as Deferred Revenue Expenditure and charge it off to revenue over a period of three to five years, as circumstances would admit.

CASH AT BANK

The auditor should reconcile the balance shown by the Pass Book with the Bank Account or the Bank Columns of the Cash Book, and obtain a certificate from the Bankers. If the audit takes place long time after the date of the Balance Sheet, it is advisable to reconcile both right up to date.

CASH IN HAND

With regard to cash in hand, where this amounts to a fairly large sum, the auditor should verify this by actual counting on the last day of the period under audit. In a large business, where several cashiers are employed, it is necessary that the cash of each one should be counted simultaneously. If there are cheques or I. O. U.s making up the balance, the auditor should satisfy himself that they are genuine by making inquiries from some person in authority.

THE LIABILITIES SIDE OF THE BALANCE SHEET

SHARE CAPITAL

The steps to be taken by the auditor in connection with the verification of the Share Capital figures have already been fully described in the previous Chapter. Once the Share Capital transactions are exhaustively checked in the first year, it is only necessary to verify the figures in respect of further calls made and received, if any, or any fresh capital issued in the subsequent years.

The various Funds which follow the item of Share Capital in the Prescribed Form have been made the subject matter of a separate Chapter, and they need not, therefore, be discussed here.

LOANS ON MORTGAGE OR MORTGAGE DEBENTURE BONDS

The auditor must very carefully ascertain the company's borrowing powers. Whether a company has power to borrow or not depends upon its objects, and the auditor must refer to the Memorandum and Articles for this purpose. A power to borrow, however, need not be express. It may be implied, and all trading companies have an implied power to borrow, as the same is regarded as incidental to the carrying on of their business. If

there is any limit placed on the borrowing powers of the directors or the managing agents, the auditor should see that such limit is not exceeded.

It will be the auditor's duty to see that all the requirements of the Act in connection with Loans on Mortgage are rigidly carried out. The auditor should also see that the assets mortgaged or charged are clearly so indicated on the Balance Sheet.

Where Debentures are issued at a premium, such premium can be applied towards payment of dividend, in the absence of any provisions to the contrary, but such a practice is not sound from a financial standpoint. The more desirable way to deal with it would be to use it towards reduction or writing off of goodwill or other fixed assets, or to credit it to Debenture Redemption Fund or to Capital Reserve Fund.

Where Debentures are issued at a discount and are repayable at par, the total amount of liability represented by the face value of the Debentures must be shown on the liabilities side. The Discount on Issue of Debentures, being a loss, would be written off during the term of the Debentures, the unwritten balance being shown on the assets side in the meantime.

Where Debentures are issued at par and are repayable at a premium, it will be necessary to provide for the loss on account of premium proportionately out of the profits of each year.

The auditor must consult the terms of issue of the Debentures to see if there are any specific conditions attached thereto in regard to provision for the redemption. If there be any such conditions, he should see that they are complied with.

REGISTRATION OF MORTGAGE

Section 109 of the Indian Companies Act requires every mortgage or charge created by the company under any of the following heads to be properly filed with the Registrar within 21 days from the date of its creation, viz.:—

- (a) A mortgage or charge, for the purpose of securing any issue of Debentures; or
- (b) A mortgage or charge on uncalled share capital of the company; or
- (c) A mortgage or charge on any immovable property wherever situate, or any interest therein; or
- (d) A mortgage or charge on any Book Debts of the company; or
- (e) A mortgage or a charge, not being a pledge on any movable property of the company except stock-in-trade; or
- (f) A floating charge on the undertaking or property of the company.

LOANS SECURED AND UNSECURED

Loans received otherwise than by issue of debentures will have to be separately stated. In regard to the secured loans, these will have to be shown under their appropriate heading and carefully sub-divided as required under the Form F, and the nature of securities must appear against each such loan. The interest accrued on any of such loans and due to the date of the Balance Sheet will also have to be brought into account and shown separately. If there are any liabilities due to any of the subsidiary companies, these will also have to be shown under their distinct heading. The unsecured loans will appear underneath those secured and will also have to be classified under their distinctive heads as required under the Form. Interest accrued on these to date of Balance Sheet will also have to be separately stated.

INTEREST ACCRUED ON LOANS

The auditor should see that the Interest on Loans (secured as well as unsecured) due to the end of the financial period, if not paid, is brought into account and shown as a distinct liability in the Balance Sheet.

OTHER LIABILITIES

All liabilities other than for Loans Secured and Unsecured as stated above would have to be distinguished as follows:—

- (a) Liabilities for Goods bought.
- (b) „ for Expenses.
- (c) „ for Acceptances (i.e. Bills Payable).
- (d) „ for other finance.

The auditor must see that all liabilities are grouped under their appropriate headings, as shown above, and he must specially guard against any under-statement or omission of these.

He must carefully scrutinise all expense Accounts to ascertain that no outstanding liabilities have been omitted. For his own protection, the auditor would do well to secure a Certificate from the Manager or the Managing Director or the Managing Agents of the company to the effect that all outstanding liabilities in regard to the goods purchased and the expenses incurred and appertaining to the period under audit have been duly brought into account.

ADVANCE PAYMENTS

Under this head, would appear any amount received by the company in return for which it has not rendered full benefit or service in the current period. For instance, a newspaper company might have received annual subscription and advertisement moneys in advance from subscribers and

advertisers, but the whole of the period covered by such subscription and advertisement moneys may not have expired concurrently with the date of the financial closing. Under such a circumstance, subscription and advertisement moneys applicable to the period under audit only would be transferred to Revenue and the balance in respect of which the benefit is still to be imparted will be carried forward as a liability, under the heading of Advance Payments.

UNEXPIRED DISCOUNTS

This item would only arise in case of Banks or Finance Companies whose business would be to discount Bills of Exchange on a large scale. In this case, the proportionate discounts on such Bills as remain unmatured at the date of the Balance Sheet will have to be transferred from the credit of Discount Account to an Account styled Rebate on Bills Discounted, and would then appear as a liability under the above head, representing discounts received in the current year but properly applicable to the next period.

CONTINGENT LIABILITIES

Contingent liabilities are liabilities which have not arisen or have already accrued, but may arise out of transactions pending upon the happening of a certain event. Thus a contingent liability may or may not involve the payment of money.

Among instances of Contingent Liabilities may be quoted:—(1) Liability for Calls on partly paid shares held; (2) Liability on Bills Receivable discounted and not matured; (3) Liabilities under a Guarantee; (4) Liabilities for Penalties under Contracts; and (5) Liability in respect of arrears of Dividend on Cumulative Preference Shares.

While preparing a Balance Sheet, only the liabilities that have actually accrued due to the date of the financial close should necessarily be brought into account. The Form of Balance Sheet prescribed under the Indian Companies Act, however, requires that Contingent Liabilities should be stated in the shape of a Note appended to the Balance Sheet, at the foot of the liabilities side.

The amount of any guarantees given by the company on behalf of directors or officers is required to be separately shown under this head.

If there are any claims made against the company and not acknowledged as debts, the same should also be included amongst Contingent Liabilities.

The auditor must ascertain after making enquiries from those in management as to whether there are any of the contingent liabilities as stated above, at the date of the Balance Sheet. If there be any such, he should insist upon a statement being made to that effect under the heading of Contingent Liabilities on the liabilities side of the Balance Sheet.

FORM F

The Form F marks no doubt a considerable improvement on the Balance Sheet so far published, and if the Auditor takes the trouble to see that it is rigidly adhered to in all its details, he will have faithfully carried out his duty to the shareholders whose nominee he is. The whole object of the Balance Sheet is to place before the shareholders a full and fair statement reflecting a true picture of the exact financial condition of the company on one particular date, and the auditor's duty is to see that all the items embodied in the Balance Sheet are presented and classified under their appropriate heads, that all these have been valued on basis accepted as sound and correct, and that no fact is concealed which if disclosed would create a different impression from the one conveyed by the Balance Sheet.

CHAPTER VII

SOME FURTHER FEATURES OF A COMPANY AUDIT

APPOINTMENT AND QUALIFICATION OF DIRECTORS

Subject to any regulations in the Articles of the Company, the subscribers to the Memorandum are deemed to be the first directors of the company until the directors are appointed by the members in general meeting. Any casual vacancy arising among the directors may be filled up by the directors. [Section 83B (1)].

Section 84 places some restrictions on appointment of directors to public companies as under:—

No person shall be named as a director in the Articles or the Prospectus or the Statement in lieu of Prospectus of a public company unless he has previously filed a written consent to act as a director, and has either:—

- (1) Signed the Memorandum for his qualification shares; or
- (2) Taken from the company and paid, or agreed to pay for those shares; or
- (3) Signed and filed with the Registrar a contract in writing to take those shares and pay for them; or
- (4) Filed with the Registrar an affidavit that the number of shares not less than his qualification are registered in his name.

It is not legally necessary that the directors should be shareholders, but the Articles usually contain a provision that each director should hold a certain number of shares to qualify him for such office. A director is fully qualified if he holds the required number of shares jointly with others. Qualification shares would be deemed to have been properly acquired either by taking them up from the company or by way of transfer, in the absence of anything to the contrary in the Articles. The number of shares fixed by the Articles as the qualification of a director must be disclosed in the Prospectus.

The auditor should see that the prescribed qualification shares are acquired by each director within two months of his appointment, or such shorter time as may be fixed by the Articles. If the qualification shares are not acquired within the stipulated time, or if any director ceases to hold his qualification shares, the office of such director becomes automatically vacated. The fact, however, that a director has failed to take up his qualification shares does not invalidate any of the acts or proceedings to which such director has been a party, but it makes him liable to a heavy penalty.

DIRECTORS' REMUNERATION

A director is not entitled to any fee unless the Articles allow the same or the shareholders have fixed it at the General Meeting. The auditor should see that the amount paid to each director is in terms of the Articles or the Resolution of the shareholders.

The payments for the fees should be vouched with the receipts given by the Directors, or with the returned endorsed cheques, in the absence of any receipts.

The Register of Directors and Managers should be examined to ascertain who the directors of the company are. If the fee is payable per each attendance at the Board's Meeting, the Directors' Attendance Book will have to be examined and the amount paid to each director agreed.

If any doubt arises as to the basis of calculation of Directors' Fees, the matter should be referred to the shareholders in General Meeting.

If the Directors forego their right to the Fees they are entitled to, the auditor should see the minute to that effect passed at a meeting at which all the directors are present, and signed by the chairman.

Any remuneration payable to directors but remaining unpaid at the date of the Balance Sheet should be provided for as an outstanding liability, unless the directors have agreed to waive their claim to the same in writing and the fact has been duly minuted.

Section 132 (3) requires the compulsory disclosure in the Profit and Loss Account of the total remuneration paid to the managing agents and the directors for their services, in shape of fees, percentages or other emoluments, and the auditor should see that this is done. Further, if any director is by virtue of nomination a director of any other company, any remuneration or emoluments received by him as such should be shown by way of a foot-note.

Any provision in the Articles or in any contract as to the remuneration to directors and managing agents is required to be disclosed in the Prospectus.

DIRECTORS' TRAVELLING EXPENSES

Directors are not entitled to receive travelling expenses incurred by them for attending Board Meetings, unless the Articles or a resolution at a General Meeting specifically allow these.

Any other expenses or outlays incurred by the directors specifically in connection with the company's business are allowed to be reimbursed.

MANAGING DIRECTOR'S REMUNERATION

The Articles generally authorise the directors to appoint a Managing Director and fix his remuneration. The auditor should see that the appointment is in order, that it is properly minuted, and that the remuneration paid is in terms of the minute. Where there is an agreement with the Managing Director, it should be seen that all payments are in accordance therewith.

Where the Managing Director is entitled to receive a certain percentage on the net profits in payment of the whole or a part of his remuneration, in the absence of anything to the contrary in the agreement, the "net profits" would be considered to be the profits before charging such a percentage.

Where the percentage of commission is stated in the agreement to be on the "divisible net profits", the auditor should most carefully consult the company's Articles to ascertain how capital gains, if any, are to be dealt with and must carefully examine the wordings of the agreement in question. "Trading Profits" would mean any net gain made in the usual course of the business, and would exclude any capital profits or profits made outside the usual course of the business. Unless otherwise provided by the Articles or the agreement, the provision for income-tax or other appropriations out of profit cannot be treated as a charge before arriving at the figure on which to calculate the required percentage. In the absence of anything to the contrary, depreciation on fixed assets must be treated as a business charge.

QUORUM AT DIRECTORS' MEETINGS

The Directors' Minute Book should be inspected to see that all matters affecting accounts are duly dealt with by a properly constituted quorum.

Where a director is personally interested in a matter which is being considered by the Board, his presence cannot be counted for the purpose of making a quorum.

The Articles usually fix or permit the directors to fix the quorum necessary for the transaction of the business by the directors.

In this connection, Clause 88 of Table A states as under:—

"The quorum necessary for the transaction of the business of the directors may be fixed by the directors, and unless so fixed shall (when the number of directors exceeds three) be three."

The above Clause is not compulsorily required to be adopted by every company.

DIRECTORS AND THEIR POWERS OF MANAGEMENT

The NEW PROVISIONS regarding directors are very important and may be summarised as under:—

MINIMUM NUMBER OF DIRECTORS

Section 83A requires that every company shall have at least THREE directors instead of two. This will not apply to a private company, except a private company which is a subsidiary of a public company.

TWO-THIRDS TO RETIRE BY ROTATION

Under Section 83B (2), notwithstanding anything contained in the Articles, NOT LESS THAN TWO-THIRDS of the whole number of directors shall be LIABLE TO RETIREMENT by rotation. The section is very important as it helps towards the constitution of an independent board of directors.

This provision does not apply to a company incorporated BEFORE THE COMMENCEMENT of the New Act, if its Articles provide otherwise, nor does it apply to a private company.

RESTRICTION ON ASSIGNMENT OF OFFICE

By Section 86B, the assignment of office by a director to another person, under any provision in the Articles or any agreement between the director and the company, is made subject to the approval of the shareholders by means of a special resolution. But the appointment by a director of a TEMPORARY SUBSTITUTE to act for him during his absence of NOT LESS THAN THREE MONTHS from the district in which Board Meetings are held, IF DONE WITH THE APPROVAL OF THE BOARD, will not be deemed to be an assignment.

PROVISIONS RELIEVING DIRECTORS FROM LIABILITY TO BE VOID

Section 86C renders void any provision in the Articles or any other contract relieving any director, manager, officer or auditor of the company from liability in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company.

Any such provision existing at the date of the commencement of the Amending Act shall have effect only for six months after that date.

A company may, however, indemnify any such director, manager, officer, or auditor against any liability incurred by him in defending any proceedings, civil or criminal, in which judgment is given in his favour.

LOANS OR GUARANTEES TO DIRECTORS

Section 86D is of special interest to auditors as it forbids any loans being granted by a company to any of its directors, or any guarantees being given by a company in respect of any loans contracted by any of its directors. This prohibition relates also to partnerships in which a director is a partner, and to private companies in which such director is a director. If, however, the business of the company is that of banking, there is no legal objection to any of its directors borrowing as ordinary customers.

It must be noted that similar provisions forbidding loans to managing agents have also been made under Section 87D.

Where loans granted to directors are within the legal powers of the company, the auditor should make sure that the transactions are in order, and that all interest thereon has been paid as and when due. Where any interest has been overdue for long, the auditor should pointedly refer to the matter in his report. The auditor should also satisfy himself that such loans have not been advanced at anything less than the rate of interest chargeable to others.

Where the directors have withdrawn sums beyond what is due to them in respect of their remuneration and outlays, such an excess drawing should be treated as a loan and shown under its distinct heading on the Balance Sheet, as required by Form F.

An important point to be borne in mind by the auditor is that such loans even in shape of temporary advances made to the directors or managers during the year, must be stated by way of a note in the Balance Sheet, even if the same have been repaid during the year under audit.

A private company other than a subsidiary of a public company is exempt from this Section. Section 86D enacts as under:—

Section 86D.—(1) No company shall make any loan or guarantee any loan made to a director of the company or to a firm of which such director is a partner or to a private company of which such director is a director.

(2) In the event of any contravention of sub-section (1) any director of the company who is a party to such contravention shall be punishable with fine which may extend to five hundred rupees, and if default is made in repayment of the loan or in discharging the guarantee, shall be liable jointly and severally for the amount unpaid.

(3) This section shall not apply to a private company (except a private company which is the subsidiary company of a public company) or to a banking company.

LOANS FROM DIRECTORS

Balances on loans advanced to the company by the directors, if any, outstanding at the date of Balance Sheet must be shown under a distinct heading on the liabilities side of the Balance Sheet, as required under Form F. The auditor should see, in such a case, that the loans are not *ultra vires* and that the directors have not taken any undue advantage of their position by charging the company an excessive rate of interest.

DIRECTOR NOT TO HOLD OFFICE OF PROFIT

Except with the consent of the company in general meeting, no director, or a firm of which such director is a partner, or a private company of which such director is a director, will be entitled to hold any office of profit under the company except that of a managing director or a manager, or a legal or technical adviser, or a banker. The office of a managing agent is not to be deemed as an office of profit for the purpose of this section. The section, however, does not affect any office of profit held by a director at the commencement of the Amending Act. Section 86E lays down as under:—

Section 86E.—No director or firm of which such director is a partner or private company of which such director is a director shall without the consent of the company in general meeting hold any office of profit under the company except that of a managing director or manager or a legal or technical adviser or a banker :

Provided that nothing herein contained shall apply to a director elected or appointed before the commencement of the Indian Companies (Amendment) Act, 1936, in respect of any office of profit under the company held by him at the commencement of the said Act.

Explanation.—For the purposes of this section, the office of managing agent shall not be deemed to be an office of profit under the company.

RESTRICTION ON DIRECTORS CONTRACTING WITH COMPANY

Section 86F forbids (a) a director of the company, or (b) the firm of which he is a partner, or (c) any partner of such firm, or (d) the private company of which he is a member or director from entering into any contract with the company for the sale, purchase or supply of goods and materials except with the consent of the directors.

Any existing contract or arrangement entered into before the commencement of the Amending Act will not be affected by this section.

Section 86F.—Except with the consent of the directors, a director of the company, or the firm of which he is a partner or any partner of such firm, or the private company of which he is a member or director, shall not enter into any contracts for the sale, purchase or supply of goods and materials with the company, provided that nothing herein contained shall affect any such contract or agreement for such sale, purchase or supply entered into before the commencement of the Indian Companies (Amendment) Act, 1936.

There is a similar restriction on managing agents contracting with their company, under section 87D, but in their case, three-fourths of the directors present and entitled to vote on the resolution can sanction such contracts.

DISCLOSURE OF INTERESTS OF DIRECTORS

Under Section 91A, if any director is directly interested in a contract or proposed contract with the company, he should declare his interest at a meeting of the directors at which such contract is determined on, or where a contract is already made, he should declare his interest at the earliest meeting of the directors after the acquisition of his interest or the making of the contract or arrangement.

A Register of such Contracts is required to be compulsorily maintained giving full details of each such contract, and the same should be open to inspection of any shareholder at the registered office during business hours.

Section 91A.—(1) Every director who is directly or indirectly concerned or interested in any contract or arrangement entered into by or on behalf of the company shall disclose the nature of his interest at the meeting of the directors at which the contract or arrangement is determined on, if his interest then exists, or in any other case at the first meeting of the directors after the acquisition of his interest or the making of the contract or arrangement :

Provided that a general notice that a director is a director or a member of any specified company or is a member of any specified firm, and is to be regarded as interested in any subsequent transaction with such firm or company, shall as regards any such transaction be sufficient disclosure within the meaning of this sub-section and after such general notice, it shall not be necessary to give any special notice relating to any particular transaction with such firm or company.

(2) Every director who contravenes the provisions of sub-section (1) shall be liable to a fine not exceeding one thousand rupees.

(3) A register shall be kept by the company in which shall be entered particulars of all contracts or arrangements to which sub-section (1) applies, and which

shall be open to inspection by any member of the company at the registered office of the company during business hours.

(4) Every officer of the company who knowingly and wilfully acts in contravention of the provisions of sub-section (3) shall be liable to a fine not exceeding five hundred rupees.

PROHIBITION OF VOTING BY INTERESTED DIRECTOR

Under Section 91B, the director who is interested in any contract is prohibited from voting at the board meeting at which he declares his interest, and his presence will not be counted for the purpose of forming a quorum at the time of any such vote.

Section 91B. (1) No director shall, as a director, vote on any contract or arrangement in which he is either directly or indirectly concerned or interested nor shall his presence count for the purpose of forming a quorum at the time of any such vote; and if he does so vote, his vote shall not be counted :

Provided that the directors or any of them may vote on any contract of indemnity against any loss which they or any one or more of them may suffer by reason of becoming or being sureties or surety for the company.

(2) Every director who contravenes the provisions of sub-section (1) shall be liable to a fine not exceeding one thousand rupees.

(3) This section shall not apply to a private company :

Provided that where a private company is a subsidiary company of a public company, this section shall apply to all contracts or arrangements made on behalf of the subsidiary company with any person other than the holding company.

Where there is any contract, in which a director is interested, the auditor should refer to the Board's Minute recording such a declaration made by the director interested, and see that his vote, even if he has been present at the meeting, is not counted for the quorum necessary for the sanction. He should further satisfy himself that any such contract is duly recorded in the Register of Contracts.

RESTRICTION ON SALE OF UNDERTAKING BY DIRECTORS

Section 86H prevents the directors of a public company or the subsidiary of a public company from disposing of the undertaking of the company or from remitting any debt due by a director, without the sanction of the shareholders in general meeting.

REMOVAL OF DIRECTORS

Section 86G empowers the shareholders by an EXTRAORDINARY RESOLUTION to remove any director liable to retire by rotation before the expiration of his period of office, and to appoint another director in his place by ORDINARY RESOLUTION.

This Section does not affect directors appointed prior to the commencement of the Amending Act, 1926.

VACATION OF OFFICE OF DIRECTOR

Section 86I lays down the conditions under which the office of a director will be deemed to be vacated, as under:—

- (a) If, he fails to obtain qualification shares within two months after his appointment, or at any time ceases to hold qualification shares; or
- (b) is adjudged an insolvent or is found by the Court to be of unsound mind; or
- (c) fails to pay calls within six months from the date of such calls; or
- (d) accepts or holds any prohibited office of profit without sanction of the shareholders in general meeting; or
- (e) takes any loan or guarantee from the company contrary to the provisions in the Act; or
- (f) absents himself from three consecutive meetings of the directors or from all the meetings of the board for three months continuously whichever is longer, without sanction of the board; or
- (g) enters into any contract with the company for the sale or purchase of goods without the consent of the directors.

Articles may provide additional grounds for vacation of office.

MANAGING AGENTS AND THEIR POWERS

Amongst the important changes brought about by the Amending Act are the provisions which set out, for the first time, the powers and responsibilities of the Managing Agents.

DEFINITION OF MANAGING AGENT

Whereas the Old Act contained no reference to managing agents, the Amending Act now specifically regulates their position, and embodies clauses relating to their appointment, powers and responsibilities, remuneration, continuance and dismissal. A managing agent is now included among the officers of the company and is defined by Section 2 (9A) as a person, firm or company entitled to the management of the whole affairs of a company by virtue of an agreement and SUBJECT TO THE CONTROL AND DIRECTION OF THE DIRECTORS, except to the extent, if any, otherwise provided for in the agreement. It is thus clear beyond doubt that the managing agents would henceforward be under the control and direction of the directors except to the extent to which the latter might themselves delegate their functions to the agents.

The main provisions applicable to managing agents are as under:—

DURATION OF OFFICE OF MANAGING AGENTS

Section 87A lays down that—

- (a) No new managing agent shall be appointed to hold office continuously for more than 20 years.
- (b) No existing managing agent can continue for more than 20 years after the commencement of this Act, unless by way of a re-appointment.
- (c) On termination of his office, a managing agent is entitled to a charge on the assets of the company by way of indemnity for all liabilities or obligations properly incurred by him on behalf of the company.
- (d) These provisions do not apply to a private company except a subsidiary of a public company.

CONDITIONS APPLICABLE TO MANAGING AGENTS

Section 87B contains the following provisions:—

Notwithstanding anything to the contrary in the Articles or in any agreement with the Company—

- (a) A managing agent may be removed by a resolution at a general meeting, if he is convicted of certain non-bailable offences in connection with the affairs of the company.
- (b) The office of the managing agent shall be vacated if he is adjudged an insolvent.
- (c) A transfer of his office by a managing agent shall be void unless approved by the company in general meeting. But a change in the constitution of the managing agents' firm is not a transfer, so long as at least one of the original partners continues to be a partner.
- (d) Any charge or assignment of his remuneration effected by a managing agent shall be void as against the company.
- (e) The appointment of a managing agent, his removal, or any variation of the agency agreement made after the commencement of the New Act shall not be valid unless approved by the company in general meeting. These conditions will, however, not apply to the appointment of the company's first managing agent made prior to the issue of prospectus or statement in lieu of prospectus in which the terms of such appointment are set forth.

REMUNERATION OF MANAGING AGENTS

The question of Managing Agents' Remuneration must in every case come under the close scrutiny of the auditor, and the new enactment in

Under Section 87C, the remuneration of a managing agent APPOINTED AFTER THE NEW ACT, must be based on a fixed percentage of the net annual profits. There can be a provision for a minimum payment in case of inadequacy of profits and an office allowance to be defined in the agreement. Any additional remuneration or one in any form other than as specified above will not be binding unless sanctioned by a special resolution of the shareholders.

“Net Profits” for the purposes of this Section are defined, and items which are to be deducted from the gross profits are enumerated. Thus, out of the gross profits the usual working charges, interest on loans and advances, repairs and outgoings, depreciation, bounties and subsidies received from Government or from a public body, profits by way of premium on shares sold, or sale proceeds of forfeited shares, or profit accruing from sale of whole or part of the undertaking of the company are to be deducted, but no deduction is to be made in respect of income-tax, super-tax or any other tax or duty on income, or for expenditure by way of interest on debentures or otherwise on capital account or for amounts appropriated out of profits towards reserve or other funds.

Section 87C.—(1) Where any company appoints a managing agent after the commencement of the Indian Companies (Amendment) Act, 1936, the remuneration of the managing agent shall be a sum based on a fixed percentage of the net annual profits of the company, with provision for a minimum payment in the case of absence of or inadequacy of profits, together with an office allowance to be defined in the agreement of management.

(2) Any stipulation for remuneration additional to or in any other form than the remuneration specified in sub-section (1) shall not be binding on the company unless sanctioned by a special resolution of the company.

(3) For the purpose of this section, ‘net profits’ means the profits of the company calculated after allowing for all the usual working charges, interest on loans and advances, repairs and outgoings, depreciation, bounties or subsidies received from Government or from a public body, profits by way of premium on shares sold, profits on sale proceeds of forfeited shares, or profits from the sale of the whole or part of the undertaking of the company but without any deduction in respect of income-tax or super-tax, or any other tax or duty on income or revenue or for expenditure by way of interest on debentures or otherwise on capital account or on account of any sum which may be set aside in each year out of the profits for reserve or any other special fund.

(4) This section shall not apply to a private company except a private company which is the subsidiary company of a public company or to any company whose principal business is the business of insurance.

Before passing the item of managing agents’ remuneration, the auditor should satisfy himself that the amount payable is ascertained in strict accordance with the managing agency agreement or as sanctioned by the resolution of the shareholders. It needs to be pointed out that the managing agents may be remunerated by a commission on sales, or production or by any other method, or they may be remunerated by a percentage of net annual

profits defined by the agreement of management and not as in sub-section (3) above, but in such a case, the remuneration must be sanctioned by a special resolution of the shareholders.

This section does not apply to a private company except a subsidiary of a public company or a company whose principal business is insurance.

LOANS TO MANAGING AGENTS

Under Section 87D, a company is not allowed to make or guarantee a loan to a managing agent, his partner, or to his private company. This does not apply to any credit allowed to a managing agent in a current account for the purposes of the company's business, subject to limits previously approved by the directors.

This does not apply to a private company, unless it is a subsidiary of a public company.

Section 87D. (1) No company shall make to a managing agent of the company or to any partner of the firm, if the managing agent is a firm, or to any director of the private company, if the managing agent is a private company, any loan out of moneys of the company or guarantee any loan made to a managing agent.

(2) Nothing contained in this section shall apply to any credit held by a managing agent in a current account maintained subject to limits previously approved by the board of directors by the company with the managing agent for the purposes of the company's business.

(3) In the event of any contravention of sub-section (1), any director of the company who is a party to the making of the loan or giving of the guarantee shall be punishable with fine which may extend to five hundred rupees, and if default is made in repayment of the loan or discharging the guarantee shall be liable jointly and severally for the amount unpaid.

(4) Nothing in this section shall apply to a private company except a private company which is the subsidiary company of a public company.

(5) Except with the consent of three-fourths of the directors present and entitled to vote on the resolution, a managing agent of the company, or the firm of which he is a partner, or any partner of such firm, or, if the managing agent is a private company, a member or director thereof, shall not enter into any contract for the sale, purchase or supply of goods and materials with the company, provided that nothing herein contained shall affect any such contract for such sale, purchase or supply entered into before the commencement of the Indian Companies (Amendment) Act, 1936.

Where a current account is opened in the managing agents' name, the auditor should satisfy himself that the account is exclusively FOR THE PURPOSES OF THE COMPANY'S BUSINESS even if it carries any interest, and is operated upon for payments on account of the company. He should further ascertain that the limit fixed by the Board is not exceeded. The sanction of the Board must be by means of a resolution of an independent quorum excluding the directors interested in the Managing Agents' firm. If on scrutiny and due enquiry, the auditor finds that no apparent purpose of the company was served, but that such current account had been opened with a view to

accommodate the managing agents, it would be his duty to report the fact to the shareholders, even if such account may have been closed within the financial period.

The Form F of Balance Sheet requires any loan or temporary advances made to DIRECTORS and MANAGERS AT ANY TIME DURING THE YEAR to be stated distinctly on the Balance Sheet under the heading of advances, and it seems that a similar statement will have to be made in case of any loan or temporary advance to MANAGING AGENTS.

RESTRICTIONS ON MANAGING AGENTS CONTRACTING WITH COMPANY

Sub-section (5) of Section 87D as above quoted restricts the managing agents from entering into contracts with their company for the sale, purchase or supply of materials or goods to the company without the previous sanction of an independent quorum of at least three-fourths of the directors present and entitled to vote on the resolution at the meeting at which the contract is being dealt with.

Where there is any such contract, the auditor should see that the necessary sanction of the Board has been obtained.

LOANS FROM MANAGING AGENTS

Where the managing agents have made any loan to the company, the balance, if any, standing on such loan account at the close of the financial period must be disclosed on the liabilities side as a separate item under the heading of Loans Unsecured, as required by Form F of Balance Sheet. Where any such loan exists, the auditor should determine if such loans are within the borrowing powers of the company. He should also make sure that they do not carry any higher rate of interest than would be ordinarily payable at the time, as that would be inconsistent with the fiduciary position of the managing agents.

INTER-COMPANY LOANS.

Section 87E.—(1) No company incorporated under this Act after the commencement of the Indian Companies (Amendment) Act, 1936, which is under the management of a managing agent shall make any loan to or guarantee any loan made to any company under management by the same managing agent, and no company shall after the expiry of six months from the commencement of the said Act except by way of renewal of an existing loan or guarantee given make any loan to or guarantee any loan made to any such company :

Provided that nothing herein contained shall apply to loans made or guarantees given by a company to or on behalf of a company under its own management or loans made by or to a company to or by a subsidiary company thereof or to guarantees given by a company on behalf of a subsidiary company thereof.

(2) In the event of any contravention of the provisions of this section, any director or officer of the company making the loan or giving the guarantee who is

knowingly and wilfully in default shall be liable to a fine not exceeding one thousand rupees, and shall be jointly and severally liable for any loss incurred by the company in respect of such loan or guarantee.

This section prohibits a company from advancing moneys or guaranteeing any loan given by a third party to any other company under management of the same managing agents, after the commencement of the Amending Act. There should also be no renewal of any such existing loan or guarantee already given after six months from the commencement of the Act. This restriction will not apply in a case where there is even a slight change in the constitution of the managing agents of the company giving the loan and the one receiving it.

It would be the duty of the auditor to make a pointed reference in his report to any loans that he may find as having been granted in contravention of this section.

INTER-COMPANY INVESTMENTS

Section 87F lays down as under:—

Section 87F.—A company other than an investment company, that is to say, a company whose principal business is the acquisition and holding of shares, stocks, debentures or other securities, shall not purchase shares or debentures of any company under management by the same managing agent, unless the purchase has been previously approved by a unanimous decision of the board of directors of the purchasing company.

This section prevents managing agents from investing the funds of a company under their management in the purchase of shares or debentures of any other company which is also under their management, unless such purchase has been previously approved by the unanimous decision of the board of directors of the purchasing company. Investment Companies are exempted from the operation of this Section.

An auditor should see that any such inter-company investment is duly supported by the previous unanimous sanction of the board as above stated.

RESTRICTION ON POWERS OF MANAGING AGENTS

Section 87G prevents a managing agent from issuing debentures, and restricts his powers to invest the funds of the company except with the authority of the directors, and within the limits fixed by them.

Section 87G.—A managing agent shall not exercise in respect of any company of which he is a managing agent a power to issue debentures or, except with the authority of the directors, and within the limits fixed by them, a power to invest the funds of the company, and any delegation of any such power by a company to a managing agent shall be void.

Where debentures are issued, the auditor will have to see the resolution of the Board authorising such an issue. In case of investment of the company's funds, the auditor will have to ascertain that the managing agents have carried out the transactions under authority from the Board and within the limits fixed by the latter.

MANAGING AGENT NOT TO CARRY ON COMPETING BUSINESS

Under Section 87H, a managing agent shall not on his own account engage in a business which is of the same nature as and which directly competes with the business carried on by his company or its subsidiary.

LIMIT OF DIRECTORS APPOINTED BY MANAGING AGENTS

Section 87I provides that notwithstanding anything contained in the Articles, the directors, if any, appointed by the managing agents, shall not exceed one-third of the total number of directors. This does not apply to a private company.

DISCLOSURE IN PROSPECTUS

By Section 93 (1) (c), the Prospectus is required to disclose any provision in the Articles or in any agreement as to the appointment of managers or managing agents and the remuneration payable to them.

DISCLOSURE TO MEMBERS

Section 91C requires any contract for the appointment of a manager or managing agent in which contract any director is directly or indirectly concerned or interested, or any variation of such an existing contract to be reported to the members of the company within 21 days. The contract will also have to be open to the inspection of any member at the registered office of the company.

STATUTORY BOOKS

In addition to proper financial Books of Account, the following Registers are also compulsorily required to be maintained by every company:—

(1) Minute Books, for recording Minutes of proceedings of meetings of (a) Directors, and (b) Members (Section 83);

(2) Register of Members (Section 31);

(3) Index of Members (Section 31A);

(4) Register of Directors, Managers and Managing Agents (Section 87);

(5) Register of Contracts in which directors are interested (Section 91A);

(6) Register of Mortgages (Section 123);

(7) Annual List of Members and Summary of Share Capital (Section 32);

(8) Branch Register of Members in the United Kingdom (Section 41).

The above books are mostly of a statistical nature. The auditor's duty in connection with the record of Share and Debenture Registers is limited in the sense that once he has done the detailed checking in connection with the issue of Shares and Debentures and seen that the total issue thereof as

also the calls made, calls paid and calls in arrears as recorded in these Registers agree with similar information as is conveyed by the financial books, he need not concern himself with the transfers of shares and debentures in subsequent years. All that he need do in each subsequent year is to see that the results in the aggregate as ascertained from the Lists of Share and Debenture Holdings made out from these Registers tally with their corresponding accounts in the financial records. Further, in case of forfeiture of shares, it will be his duty to verify the entries in this connection in the Share Register. If, however, in course of his inspection, he finds that the necessary particulars as required by the Act to be embodied in any of these Registers are not entered therein, it would be his duty to bring such fact to the notice of the directors and see to the defect being remedied.

If any fresh calls have been made or additional shares are issued in the year under audit, he will have to carry out the detailed checking in respect thereof as already described.

MINUTE BOOKS

Every company is required to maintain special books for recording minutes of all proceedings at general meetings and of all proceedings at meetings of the board of directors.

Section 83.—(1) Every company shall cause minutes of all proceedings of general meetings and of its directors to be entered in books kept for that purpose.

(2) Any such minute, if purporting to be signed by the chairman of the meeting at which the proceedings were had, or by the chairman of the next succeeding meeting, shall be evidence of the proceedings.

(3) Until the contrary is proved, every general meeting of the company or meeting of directors in respect of the proceedings whereof minutes have been so made shall be deemed to have been duly called and held, and all proceedings had thereat to have been duly had, and all appointments of directors or liquidators shall be deemed to be valid.

(4) The books containing the minutes of proceedings of any general meeting of a company held after the commencement of the Indian Companies (Amendment) Act, 1936, shall be kept at the registered office of the company and shall during business hours (subject to such reasonable restrictions as the company may by its articles or in general meeting impose so that no less than two hours in each day be allowed for inspection) be open to the inspection of any member without charge.

(5) Any member shall at any time after seven days from the meeting be entitled to be furnished within seven days after he has made a request in that behalf to the company with a copy of any minutes referred to in sub-section (4) at a charge not exceeding six annas for every hundred words.

(6) If any inspection required under sub-section (4) of this section is refused, or if any copy required under sub-section (5) of this section is not furnished within the time specified in sub-section (5), the company and every officer of the company who is knowingly and wilfully in default shall be liable in respect of each offence to a fine not exceeding twenty-five rupees and to a further fine of twenty-five rupees for every day during which the default continues.

(7) In the case of any such refusal or default, the Court may by order compel an immediate inspection of the books in respect of all proceedings of general meetings or direct that the copies required shall be sent to the persons requiring them.

As the shareholders are not entitled to inspection of the Minute Book of Directors' Meetings, it is found convenient to keep two separate Minute Books, one to record minutes of proceedings at Board Meetings and the other for minutes of Shareholders' Meetings.

Both the Directors' and the Shareholders' Minute Books should be inspected by the auditor to satisfy himself that the various transactions of the company are duly authorised, and to ascertain if there are any resolutions affecting accounts.

The Directors' Minute Book would have to be inspected in connection with the following matters:—

- (1) The issue of Share Capital.
- (2) The allotment of Shares.
- (3) Calls made on Shares.
- (4) Issue of Debentures.
- (5) Appointment and remuneration of Secretary and other officials.
- (6) Appointment and remuneration of Managing Director.
- (7) Appointment and remuneration of Auditors prior to general meeting or for filling a casual vacancy.
- (8) Adoption of Agreements and Contracts.
- (9) Forfeiture of Shares.
- (10) Adoption of Annual Accounts to be published.
- (11) Loan arrangements with Bankers.
- (12) Declaration of Interim Dividends.
- (13) Authorization of Capital Expenditure.

The Shareholders' Minute Book would ordinarily authorise the following transactions:—

- (1) The passing and adoption of the Annual Accounts.
- (2) Declaration of Dividend.
- (3) Transfers to Reserves.
- (4) Appointment and Remuneration of Directors.
- (5) Appointment and Remuneration of Auditors.
- (6) Alteration of Articles.

REGISTER OF MEMBERS

Every company must maintain a Register of Members and enter therein the following particulars:

Section 31.—(1) Every company shall keep in one or more books a register of its members, and enter therein the following particulars:—

(i) the names and addresses, and the occupations, if any, of the members and, in the case of a company having a share capital, a statement of the shares held by each member, distinguishing each share by its number, and of the amount paid or agreed to be considered as paid on the shares of each member ;

(ii) the date at which each person was entered in the register as a member ;

(iii) the date at which any person ceased to be a member.

(2) If a company makes default in complying with the requirements of this section, it shall be liable to a fine not exceeding fifty rupees for every day during which the default continues ; and every officer of the company who knowingly and wilfully authorises or permits the default shall be liable to the like penalty.

INDEX OF MEMBERS

Section 31A enacts as under:—

Section 31A.—(1) Every company having more than fifty members shall, unless the register of members is in such a form as to constitute in itself an index, keep an index of the names of the members of the company and shall within fourteen days after the date on which any alteration is made in the register of members make any necessary alteration in the index.

(2) The index, which may be in the form of a card index, shall in respect of each member contain a sufficient indication to enable the account of that member in the register to be readily found.

(3) If default is made in complying with this section, the company and every officer of the company who is knowingly and wilfully in default shall be liable to a fine not exceeding fifty rupees.

This is a new Section and requires every company to maintain an Index of Members where the Register of Members does not contain a proper index.

ANNUAL LIST OF MEMBERS AND SUMMARY OF SHARE CAPITAL

Section 32 requires a detailed list of members with their individual holdings together with a summary of the Share Capital to be filed with the Registrar within 21 days from the date of each annual general meeting. The important change under the Amending Act is the additional information to be supplied in respect of the names of the managers and managing agents, and any changes in the personnel of the directors, managers and managing agents since the last return, and the dates on which such changes took place.

A copy of the above List and Summary is required to be inserted in a separate part of the Register of Members.

Section 32.—(1) Every company having a share capital shall within eighteen months from its incorporation and thereafter once at least in every year make a list of all persons who, on the day of the first or only ordinary general meeting in the year, are members of the company, and of all persons who have ceased to be members since the date of the last return or (in the case of the first return) of the incorporation of the company.

(2) The list shall state the names, addresses, and occupations of all the past and present members therein mentioned, and the number of shares held by each of the existing members at the date of the return, specifying shares transferred since

the date of the last return or (in the case of the first return) of the incorporation of the company by persons who are still members and persons who have ceased to be members respectively and the dates of registration of the transfers, and shall contain a summary distinguishing between shares issued for cash and shares issued as fully or partly paid up otherwise than in cash, and specifying the following particulars :—

- (a) the amount of the share capital of the company, and the number of the shares into which it is divided ;
- (b) the number of shares taken from the commencement of the company up to the date of return ;
- (c) the amount called up on each share ;
- (d) the total amount of calls received ;
- (e) the total amount of calls unpaid ;
- (f) the total amount of the sums (if any) paid by way of commission in respect of any shares or debentures, or allowed by way of discount in respect of any shares or debentures, since the date of the last return or so much thereof as has not been written off at the date of the return ;
- (g) the total number of shares forfeited ;
- (h) the total amount of shares or stock for which share-warrants are outstanding at the date of the return ;
- (i) the total number of share-warrants issued and surrendered respectively since the date of the last return ;
- (k) the number of shares or amount of stock comprised in each share-warrant ;
- (l) the names and addresses of the persons who at the date of the return are the directors of the company and of the persons (if any) who at the said date are the managers or managing agents of the company, and the changes in the personnel of the directors, managers and managing agents since the last return together with the dates on which they took place ; and
- (m) the total amount of debt due from the company in respect of all mortgages and charges which are required to be registered with the registrar under this Act.

(3) The above list and summary shall be contained in a separate part of the register of members, and shall be completed within twenty-one days after the day of the first or only ordinary general meeting in the year, and the company shall forthwith file with the registrar a copy signed by a director or by the manager or the secretary of the company, together with a certificate from such director, manager or secretary that the list and summary state the facts as they stood on the day aforesaid.

(4) A private company shall send with the annual return required by sub-section (1) a certificate signed by a director or other officer of the company that the company has not, since the date of the last return or, in the case of a first return, since the date of the incorporation of the company, issued any invitation to the public to subscribe for any shares or debentures of the company, and where the annual return discloses the fact that the number of members of the company exceeds fifty, also a certificate so signed that the excess consists wholly of persons who under sub-clause (b) of clause 13 sub-section (1) of section 2 are not to be included in reckoning the number of fifty.

(5) If a company makes default in complying with the requirements of this section, it shall be liable to a fine not exceeding fifty rupees for every day during which the default continues, and every officer of the company who knowingly and wilfully authorises or permits the default shall be liable to the like penalty.

REGISTER OF DEBENTURE-HOLDERS

There is no specific provision in the Act requiring a Register of Debenture-holders to be kept by every company that has issued Debentures, but from the right to inspect the Register of Holders of Debentures given to every Debenture-holder and shareholder of the company by Section 125, it may be inferred that the Act presupposes the maintenance of such a Register. Besides, as the Debentures are transferable and as periodical interest has to be paid to individual debenture-holder, the maintenance of this Register seems to be indispensable.

Section 125.—(1) Every register of holders of debentures of a company shall, except when closed in accordance with the articles during such period or periods (not exceeding in the whole thirty days in any year) as may be specified in the articles, be open to the inspection of the registered holder of any such debentures, and of any holder of shares in the company, but subject to such reasonable restrictions as the company may in general meeting impose, so that at least two hours in each day are appointed for inspection, and every such holder may require a copy of the register or any part thereof on payment of six annas for every one hundred words or fractional part thereof required to be copied.

(2) A copy of any trust-deed for securing any issue of debentures shall be forwarded to every holder of any such debentures at his request on payment in the case of a printed trust-deed of the sum of one rupee or such less sum as may be prescribed by the company, or, where the trust-deed has not been printed, on payment of six annas for every one hundred words or fractional part thereof required to be copied.

(3) If inspection is refused, or a copy is refused or not forwarded, the company shall be liable to a fine not exceeding fifty rupees and to a further fine not exceeding twenty rupees for every day during which the refusal continues, and every officer of the company who knowingly authorises or permits the refusal shall incur the like penalty, and the Court may by order compel an immediate inspection of the register.

REGISTER OF MORTGAGES AND CHARGES

This Register is required to be maintained by every company that has mortgaged or charged any of its assets.

Section 123.—(1) Every company shall keep a register of mortgages and enter therein all mortgages and charges specifically affecting property of the company and all floating charges on the undertaking or on any property of the company, giving in each case a short description of the property mortgaged or charged, the amount of the mortgage or charge, and (except in the case of securities to bearer) the names of the mortgagees or persons entitled thereto.

(2) If any director, manager or other officer of the company knowingly and wilfully authorises or permits the omission of any entry required to be made in pursuance of this section, he shall be liable to a fine not exceeding five hundred rupees.

The auditor should verify the entries in this Register in order to ascertain the liabilities created and the assets mortgaged for the purpose of the fact being disclosed in the Balance Sheet. Under the Amending Act, all Floating Charges have also to be recorded in the Register.

REGISTER OF DIRECTORS, MANAGERS AND MANAGING AGENTS

Section 87.—(1) Every company shall keep at its registered office a register of its directors, managers and managing agents containing with respect to each of them the following particulars, that is to say :—

- (a) in the case of an individual, his present name in full, any former name or surname in full, his usual residential address, his nationality and, if that nationality is not the nationality of origin, his nationality of origin and his business occupation, if any, and if he holds any other directorship or directorships, the particulars of such directorship or directorships ;
- (b) in the case of a corporation, its corporate name and registered or principal office ; and the full name, address and nationality of each of its directors ; and
- (c) in the case of a firm, the full name, address and nationality of each partner, and the date on which each became a partner.

(2) The company shall within the periods respectively mentioned in this sub-section send to the registrar a return in the prescribed form containing the particulars specified in the said register and a notification in the prescribed form of any change among its directors, managers or managing agents or in any of particulars contained in the register.

The period within which the said return is to be sent shall be a period of fourteen days from the appointment of the first directors of the company and the period within which the said notification of a change is to be sent shall be fourteen days from the happening thereof.

(3) The register to be kept under this section shall during business hours (subject to such reasonable restrictions as the company may by its articles or in general meeting impose, so that not less than two hours in each day be allowed for inspection) be open to the inspection of any member of the company without charge and of any other person on payment of one rupee or such less sum as the company may impose for each inspection.

(4) If any inspection required under this section is refused or if default is made in complying with sub-section (1) or sub-section (2) of this section, the company and every officer of the company who is knowingly and wilfully in default shall be liable to a fine of fifty rupees.

(5) In the case of any such refusal, the Court on application made by the person to whom inspection has been refused and upon notice to the company may by order direct an immediate inspection of the register.

The object of this Section is to enable an up-to-date record in respect of the directors, managers and managing agents to be maintained with the Registrar, so that the shareholders and the public may have full information available to them in regard to the officers of the company.

The original appointment of the managing agents and of each director as also any subsequent changes will have to be filed with the Registrar within 14 days from the date of such appointment or change, in the prescribed form. The Register will be open to inspection of members during business hours without any charge, and of other persons on payment of a nominal fee.

The auditor might find it necessary to inspect this Register, when any doubt arises as to whether a particular person did really act as a director or a manager during a given period.

REGISTER OF CONTRACTS IN WHICH DIRECTORS ARE INTERESTED

Section 91A (3) requires a Register to be maintained containing particulars of all contracts or arrangements in which any director is directly or indirectly concerned or interested, and the same to be open for inspection by any member at the registered office of the company during business hours.

The auditor should ascertain that contracts, if any, for the sale, purchase or supply of goods and materials with any director of the company, or his partner, or his firm, or with any private company in which he may be a shareholder or director are duly sanctioned by the directors, as required by Section 86F, and that the requirements of Section 91A (3) as to their entry in the Register of Contracts are fully complied with. In this connection, the prohibition of voting by the interested director for the purpose of reckoning a quorum at the time of sanctioning such contract, as required by Section 91B should also be borne in mind.

DEBENTURES ISSUED AS COLLATERAL SECURITY

Where Debentures are issued as a Collateral Security to the creditors of the company to secure loans and overdrafts, a note should be made in the Balance Sheet underneath the loan indicating the amount for which Debentures have been so issued. The auditor should inspect the Directors' Minute in regard to such issue, and should also see the Loan Agreement. He must see that the entry is made in the Register of Mortgages, that the necessary particulars are filed with the Registrar, and that the fact is clearly disclosed in the Balance Sheet.

REDEMPTION OF DEBENTURES

In regard to the Redemption of Debentures, the auditor should see that the provisions in the Articles of the company as also the Debenture Trust Deed, if any, are duly complied with. If there are no conditions either in the Articles of the company or in the Debenture Trust Deed as to the creation and maintenance of a Redemption Fund, the auditor can only recommend, as a measure of sound finance, that such a fund be created.

Where debentures are redeemable at a premium and a Debenture Redemption Fund is maintained, the calculation of the amount to be set aside must provide for the nominal amount of the debentures and the premium payable on redemption.

On debentures being issued which are repayable at a premium, the auditor should see that the additional liability in respect of the premium on redemption is clearly indicated on the Balance Sheet.

Where debentures have been redeemed at a discount, the profit arising from such transactions should be credited to a capital reserve.

If the Debenture Redemption Fund is utilised in purchasing debentures in the open market and thus cancelling them, such purchases should be

treated as ordinary redemption, and any profit on cancellation should be treated as a capital reserve. In the absence of any provision to the contrary in the Articles, however, the auditor cannot prevent the company from re-transferring to revenue and distributing as dividend any profit from the redemption of the debentures in the open market at a discount. Under such a circumstance, he need only see that such an item of profit is shown under its distinct heading and not mixed up with trading profits.

On debentures being redeemed, the cancelled Debenture Certificates should be vouched by the auditors.

REDEMPTION OF REDEEMABLE PREFERENCE SHARES

In regard to the redemption of Redeemable Preference Shares as provided by Section 105B, it should be noted that it can be effected only by either:—

- (1) Out of divisible profits ; or
- (2) Out of the proceeds of a fresh issue of shares made specifically for such redemption.

Further, no such shares can be redeemed unless they are fully paid. Where the redemption is made from divisible profits, a corresponding sum should be transferred from such profits to an account styled "Capital Redemption Reserve Fund." On a redemption being made out of the proceeds of a fresh issue, the premium, if any, payable on redemption must be provided for out of the profits of the company.

The "Capital Redemption Reserve Fund" can be reduced only in accordance with the provisions of the Act relating to the reduction of the share capital of a company. Where, however, new shares have been issued in the place of those redeemed, this fund can be applied by the company to the extent of the nominal amount of the shares so issued, in paying up unissued shares of the company to be issued to the members of the company as fully paid bonus shares.

On such shares being redeemed, the auditor should examine the resolution in regard to the redemption, ascertain that the provisions of the Section 105B have been duly complied with, and the necessary transfer has been made to the fund as above said. He should further vouch the payments with the returned share certificates, and see that the necessary entries as to the redemption are made in the Register of Members. Where new shares are issued, he should verify the entries relating thereto in the financial records as also in the Register of Members.

SURRENDER OF SHARES

Usually, the directors are authorised under the Articles to accept surrender of shares under circumstances as would justify a forfeiture of shares. Surrender of shares is in fact a reduction of capital, and unless it arises under

circumstances as would justify a forfeiture, it would require the sanction of the Court.

Where there is any surrender of shares, the auditor should see that the same is authorised under the Articles and is consistent with the Act. He should inspect the Board's Minute and verify the entries in the financial books as also in the Register of Members.

ISSUE OF SHARE-WARRANTS TO BEARER

A company limited by shares, if so authorised by its Articles, can issue Share-Warrants to Bearer with respect to any of its fully-paid shares and may provide for future dividends thereon by coupons attached thereto. The bearer of such warrants will be entitled to the shares or stock specified therein, and the Share-Warrants may be transferred by mere delivery.

Where any such share-warrants are issued, the company must strike off from the Register of Members the name of the member as holder of the shares or stock specified in the warrant and shall enter in the Register the fact of the issue of the warrant as required under Section 47. Any default in complying with this section makes every officer of the company who knowingly permits the default liable to a heavy fine.

The auditor should, therefore, see that where Share-Warrants are issued, the necessary entries are made in the Register of Members.

SHARE TRANSFER AUDIT

It is not within the province of an auditor's duties to check the Register of Share Transfers. An auditor is, however, sometimes called upon to check the Share Transfers in detail and the procedure in such a case will be as follows:—

(1) Ascertain that the transferor in each case has been notified of the lodgment of the transfer, and that no objection has been raised.

(2) See that each Transfer is duly authorised by the Directors' Minute.

(3) See that all Transfer Deeds are duly stamped and executed, and that alterations, if any, are initialled.

(4) Compare the transferor's signatures on transfers with their signatures on original applications or transfers.

(5) Check each Transfer Deed into the Register of Transfers, and particularly examine the distinctive numbers of the Shares transferred.

(6) Check the entries from the Register of Transfers into the Register of Members.

(7) Examine the new Share Certificates, if issued, and see that the old certificates are cancelled or properly endorsed.

(8) See that Transfer Fees are duly accounted for.

VARIATION OF RIGHTS OF SHAREHOLDERS

Under Section 66A, if authorised by the Memorandum or the Articles, the rights attached to any class of shares may be varied subject to the consent of a specified proportion of the holders of shares of that class being obtained by means of a resolution passed at a separate meeting of the holders of those shares. On such a variation of rights, dissenting shareholders holding not less than 10 per cent of the issued capital of that class have the right to apply to the Court to have the variation of their rights cancelled. The Court after hearing the application will finally decide in the matter.

ALTERATION OF SHARE CAPITAL

Section 50.—(1) A company limited by shares, if so authorised by its articles, may alter the conditions of its memorandum as follows (that is to say), it may—

- (a) increase its share capital by the issue of new shares of such amount as it thinks expedient ;
- (b) consolidate and divide all or any of its share capital into shares of larger amount than its existing shares ;
- (c) convert all or any of its paid-up shares into stock and re-convert that stock into paid-up shares of any denomination ;
- (d) sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum, so however, that in the sub-division the proportion between the amount paid and the amount, if any, unpaid on each reduced share shall be the same as it was in the case of the share from which the reduced share is derived ;
- (e) cancel shares which, at the date of the passing of the resolution in that behalf, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled.

(2) The powers conferred by this section must be exercised by the company in general meeting.

(3) A cancellation of shares in pursuance of this section shall not be deemed to be a reduction of share capital within the meaning of this Act.

(4) The company shall file with the registrar notice of the exercise of any power referred to in clause (d) or clause (e) of sub-section (1) within fifteen days from the exercise thereof.

Where there is any alteration of share capital in any of the above ways, the auditor should see to the following:—

(1) Ascertain that the existing Articles authorise the proposed alteration of share capital, or that the necessary Article is inserted by means of a special resolution;

(2) Inspect the minutes recording the resolutions of the shareholders and ascertain that the same are in order ;

(3) Obtain Allotment Lists giving full details of the old and new holdings of shares or stock of each member and verify the same with the entries in the financial books and also in the Register of Members ;

(4) Inspect the directors' minutes in regard to allotments, consolidation, conversion or sub-division;

(5) Examine the cancelled share certificates, if any, and agree the same with the counterfoils of new stock or share certificates issued ; and

(6) See that the procedure as prescribed by the company's Articles is strictly followed in every detail.

REORGANISATION OF SHARE CAPITAL

Section 54 of the Company's Act which dealt with the Reorganisation of Share Capital has now been deleted and has been substituted by a new sub-section (6) of Section 153 which includes Reorganisation of Share Capital within the meaning of the expression " Arrangement " as used in the latter section. The result is that reorganisation of share capital will now be effected in the same manner as any arrangement between a company and its creditors or members.

On any such reorganisation taking place, the auditor should examine the Order of the Court sanctioning the same. He should also see that a copy of the Court's Order has been duly filed with the Registrar. The Journal Entries in the financial records necessitated by the change will have to be vouched, and the cancelled Share Certificates checked with the counterfoils of the new ones issued. The necessary adjustments in the Share Registers will also have to be verified.

REDUCTION OF SHARE CAPITAL

In this connection, Sections 55, 56 and 57 lay down as under:—

Section 55.—(1) Subject to confirmation by the Court, a company limited by shares, if so authorised by its articles, may by special resolution reduce its share capital in any way, and in particular (without prejudice to the generality of the foregoing power) may:—

- (a) extinguish or reduce the liability on any of its shares in respect of share capital not paid up ; or
- (b) either with or without extinguishing or reducing liability on any of its shares, cancel any paid-up share capital which is lost or unrepresented by available assets ; or
- (c) either with or without extinguishing or reducing liability on any of its shares, pay off any paid-up share capital which is in excess of the wants of the company,

and may, if and so far as is necessary, alter its memorandum by reducing the amount of its share capital and of its shares accordingly.

(2) A special resolution under this section is in this Act called a resolution for reducing share capital.

Section 56.—Where a company has passed a resolution for reducing share capital, it may apply by petition to the Court for an order confirming the reduction.

Section 57.—On and from the passing by a company of a resolution for reducing share capital, or where the reduction does not involve either the diminution of any liability in respect of unpaid share capital or the payment to any shareholder of any paid-up share capital, then on and from the making of the order confirming the reduction, the company shall add to its name, until such date as the Court may fix, the words “and reduced” as the last words in its name, and those words shall, until that date, be deemed to be part of the name of the company :

Provided that, where the reduction does not involve either the diminution of any liability in respect of unpaid share capital or the payment to any shareholder of any paid-up share capital, the Court may, if it thinks expedient, dispense altogether with the addition of the words “and reduced”.

Where the proposed reduction of capital involves either diminution of liability in respect of uncalled capital or a repayment of a part of the capital, every creditor of the company will have a right to object to the reduction, and the Court on hearing such dissentient creditors will make an order confirming the reduction only when it is satisfied that the creditors objecting have had their debts paid or secured by the company (Sections 58, 59 and 60).

A certified copy of the Court's Order confirming the Reduction and the minute in respect of such reduction must be filed with the Registrar (Section 61).

On a Reduction of Share Capital taking place, the duties of the Auditor will be practically as under:—

(1) See that the Articles authorise such a reduction, and that all the requirements in regard to the Special Resolution have been duly complied with;

(2) If the existing Articles do not contain the necessary authority see that a fresh Article to that effect is inserted by means of a Special Resolution;

(3) Verify the Special Resolution by an inspection of the Shareholders' Minute Book;

(4) Inspect the Court's Order confirming the reduction;

(5) See that the Court's Order and the Minute in respect of Reduction have been filed with the Registrar, and the Registrar's Certificate in that behalf has been received;

(6) Examine the Register of Members to ascertain that the necessary alterations have been made therein;

(7) Check the cancelled Share Certificates with the counterfoils of the New Certificates issued, or ascertain that the Old Share Certificates have been duly endorsed stating the reduction;

(8) Verify the Journal Entries giving effect to the Reduction;

(9) See that the corresponding adjustments in the valuation of each asset affected are shown distinctly in the Balance Sheet; and

(10) That the fact of the Share Capital Reduction is disclosed on the Balance Sheet with the words “and reduced” as required by the Court's Order.

PROFIT AND LOSS APPROPRIATION ACCOUNT

The net profit made by a company as appearing from its Profit and Loss Account is transferred to the credit of another account styled Profit and Loss Appropriation Account. The object of this account is to show the amount of the net profit available for disposal and how the same has been appropriated. Any balance of profit left from the previous year will appear as the first item on the credit side of this account. On the debit side of this account will appear all such items as represent allocations or appropriations of net profits, such as dividends declared, amounts set aside for Debenture Redemption Fund, Reserve Fund, Dividend Equalization Fund, etc. Provisions made in respect of Income-tax payable, as also any percentage of net profits payable to the general manager, should be charged to this account. This account must always show a credit balance representing profits not disposed of and will appear on the liabilities side of the Balance Sheet.

The auditor should see that all the appropriations of net profits are in accordance with the resolutions of the shareholders in general meeting, and the ultimate net balance on this account is properly shown in the Balance Sheet.

DIVIDENDS

The Articles of every company include provisions indicating how the annual profits should be distributed. The following Regulations in Table A, however, are compulsory for adoption by every company and the same should be noted carefully:—

Clause 95.—The company in general meeting may declare dividends, but no dividends shall exceed the amount recommended by the directors.

Clause 97.—No dividends shall be paid otherwise than out of profits (of the year or any other undistributed profits).

The directors are usually authorised by the Articles to set aside out of profits such sums as they may think proper towards reserve for contingencies or equalization of dividends or for any other purpose, before recommending any dividend. It is equally left to their discretion whether to employ such reserves in the business or invest the same in outside securities. Where the Articles give the directors such discretion, it is not open to any shareholder, even if he holds preference shares, to object to the exercise of such a right by the directors, and insist on the payment of a dividend. It will thus be seen that the primary responsibility for the distribution of profits amongst members rests with the directors.

If, however, the Articles of a company specifically lay down that the profits shall be distributed amongst the members in a particular manner, the auditor must see that such requirements are faithfully complied with.

A dividend does not become payable until there are profits and unless such dividend is declared at the General Meeting of the shareholders.

The auditor should verify the declaration of dividend with the shareholders' Minute Books and should ascertain that such declaration is made with due regard to the respective rights of the different classes of shareholders as defined in the Memorandum or Articles of Association and the Prospectus. The payments to the various shareholders should be vouched with the returned receipted dividend warrants.

A dividend becomes a debt due by the company to the shareholders as soon as it is declared, but it does not carry interest. Dividends do not become statute-barred until the expiration of six years from the date of declaration (in England twenty years), and the shareholders can legally claim them at any time within this period. Where, however, the Articles fix a period after the lapse of which unclaimed dividends can be forfeited, the directors may write back such unpaid dividends as authorised under the Articles.

Arrears of dividend upon cumulative preference shares, if any, are required to be shown as a contingent liability on the face of the Balance Sheet, under the Indian Companies Act. Where the total amounts of dividends payable to Preference and Ordinary Shareholders are transferred to separate Banking Accounts, the auditor should check the respective Dividend Lists made out from the Register of Members with their corresponding Bank Accounts and should also verify the same with the relative Pass Books. The Dividend Lists should be made out showing the gross dividend, the amount of tax deducted and the net amount payable to each shareholder.

In case of insufficient profits, if the directors have re-transferred a sum from the Reserve Fund or Dividend Equalization Fund to enable a dividend to be paid, the auditor should see that the fact is specifically indicated on the Profit and Loss Appropriation Account.

The dividend on Preference Shares is sometimes declared by the directors without reference to the shareholders in general meeting, if such a power is given to them under the Articles, and provided the company has made sufficient profits to justify such a declaration. In the absence of such express power, preference dividends also can only be declared by the shareholders like that on ordinary shares, if recommended by the directors.

INTERIM DIVIDENDS

Unlike a final dividend, an interim dividend is declared by the directors without the sanction of the members in general meeting, if the power to pay such dividends is expressly conferred by the Articles. An auditor is frequently consulted by the directors as to the desirability or otherwise of the declaration of an interim dividend. When thus approached, he should suggest the preparation of Interim Accounts in order that the profits made during the period may be ascertained. In the ascertainment of such profits, all necessary adjustments in respect of Bad Debts, Doubtful Debts, Reserve, Depreciation and Outstanding Liabilities for Expenses must be made. Great care should be exercised to ascertain how the closing stock has been valued for such purpose,

as this is the one important item capable of being manipulated to suit the requirements of those in management.

Assuming that the accounts prepared disclosed a net profit for the period, there are two important points to be considered before favouring the declaration of an Interim Dividend, viz.:—

(1) The immediate prospects of the business should be enquired into to ascertain that no losses are likely to be sustained in the remaining half year as would wipe off the profits already made during the first period; and

(2) That the company's liquid position is sound so that its cash resources are not likely to be depleted by the payment of Interim Dividend.

If the above two conditions are satisfied, there can be no objection to declaring an Interim Dividend at a considerably lower rate than the estimated dividend for the whole year. In order that the market value of its shares may not be adversely affected, a company must pay regular and stable dividends, and this is another point that needs to be watched.

In the case of Interim Dividends, the auditor should see that the Directors have power under the Articles to make such a declaration, and should inspect the Minute Book to ascertain that a resolution declaring the dividend has been duly passed by the directors.

UNCLAIMED DIVIDENDS

Unclaimed Dividends must appear as a liability under a distinct heading. Where the total amount of dividend declared and payable is transferred to a separate Bank Account, the auditor should see that the balance on this account at the close of the financial period tallies with the amount of the liability shown in the Balance Sheet under the heading of Unclaimed Dividends. Unclaimed Dividends can be forfeited after the lapse of the period, if any, mentioned in the articles and can then be credited to the Reserve Fund, although, unless there is anything to the contrary in the Company's Articles, there is nothing to prevent a company from taking credit for it in the Profit and Loss Account. In case of such a forfeiture, the auditor must make sure that the procedure is legal and must inspect the Directors' Minute in this behalf. He should further see that such a credit is shown under its distinct heading in the Profit and Loss Account.

DIVIDEND FREE OF TAX

When a DIVIDEND IS DECLARED FREE OF INCOME-TAX, it means that the gross amount of the dividend declared should be paid to the shareholders without deducting any Income-tax. On a dividend being declared, the entry would be to debit Profit and Loss Appropriation Account and credit the particular Dividend Account with the total amount of the Dividend payable. Separate Dividend Accounts should be kept for the dividends on different classes of shares. As and when the dividend is paid, Dividend Account is

debited and Bank Account is credited. If some of the shareholders have not claimed their dividends, the Dividend Account will show a credit balance representing dividends unpaid. This is a liability of the company to the shareholders and will appear on the liabilities side of the Balance Sheet under the heading of Unclaimed or Unpaid Dividends.

DIVIDEND LESS TAX

When a **DIVIDEND IS DECLARED LESS TAX**, it means that each shareholder will receive only the net amount after deducting from the gross dividend the amount of Income-tax at the appropriate rate ruling at the time of declaration of dividend. Unless a dividend is specifically declared to be **FREE OF TAX**, it is always assumed to be **LESS TAX**. The dividend on preference shares, in the absence of any provision in the Articles to the contrary, should always be paid less tax. The Income-tax deducted from a dividend declared less tax is not to be paid to the Inland Revenue authorities, since a company always pays Income-tax on its entire net profits for the year irrespective of whether these are distributed to the shareholders or not. The company by declaring a dividend less tax simply recoups a portion of the tax from the shareholders.

The auditor should carefully ascertain by reference to the Minutes whether the dividends declared have been less Tax or Free of Tax, and see that the entries made are in accordance with such declaration.

DEDUCTION OF INCOME-TAX FROM DEBENTURE INTEREST

A company is entitled to deduct income-tax at the current rate before paying interest to the debenture-holders. The income-tax thus collected will have to be handed over to the Revenue Authorities together with the tax the company has to pay on its own assessable profits.

TREATMENT OF PROFIT PRIOR TO INCORPORATION OR COMMENCEMENT CERTIFICATE

When a company takes over a running business from a date prior to the date of its own incorporation, the profits earned prior to incorporation cannot be said to have been earned by the company as it had no legal existence then, and such profits are, therefore, not legally available for the purpose of distribution as dividend. In case of a public company, it is not supposed to have legally earned profits until it has received a Certificate entitling it to commence business. Evidently, therefore, such profits are in the nature of Capital Profits and should be transferred to Capital Reserve Fund.

It need be noted, however, that in return for the loss of profits which the vendors sustain from the date of sale of their business to the date of actual payment of the purchase consideration by the company, the vendors are entitled to a certain rate of interest on the purchase price from the date the sale is effected to the date of payment; and, inasmuch as such interest

payable by the company is in return for the profits it enjoys from the date of purchase, it becomes necessary to see that the interest from the date of purchase to the date of incorporation or commencement certificate is set off as a first charge against the profits, if any, made by the company, between the above two dates. The credit balance of such profits, if any, then left after the charge in respect of the above interest, should be transferred to Capital Reserve Fund and not to the general or ordinary Reserve Fund, as the latter is available at any time for equalisation of dividend. If, however, the directors feel that the book values of some of the assets acquired are far in excess of their true present worth, they can well utilise the balance of the above profits in writing down such assets so as to bring them on a par with their present values, or in reducing the value of goodwill account, if there is any.

ASCERTAINMENT OF PROFIT PRIOR TO INCORPORATION OR COMMENCEMENT CERTIFICATE

The ascertainment of the actual profits made before incorporation is practicable only provided stock is taken and valued as at the date of the company's incorporation. As, however, in a majority of cases this is not done, the first Trading and Profit and Loss Account naturally includes the figures for the whole period, viz., from the date of purchase of the business to the close of the financial period. The net profits thus ascertained would then have to be apportioned into two periods, viz., BEFORE and AFTER the incorporation on some equitable basis. This apportionment may be done either on the basis of the periods themselves or on the basis of the respective turn-over of each of the periods. The only profits then available for dividend would be those ascertained to have been earned subsequent to incorporation, or in case of a public company, subsequent to receipt of its Commencement Certificate.

A still more reliable and accurate method for approximation of profits prior to incorporation is to apportion the gross profit between the two periods on the basis of their respective turn-overs, and then to set off against such gross profit the revenue expenses of each period. In so allocating the expenses, fixed expenses such as Office Rent, Staff Salaries, Rates, Taxes, Insurance, etc., should be apportioned on the basis of time covered by each period. On the other hand, expenses as have a direct bearing on the sales such as Commission to canvassers and sales managers, Travelling Expenses of canvassers, Advertising, etc., should be apportioned on the basis of the turn-over of each period. The expenses of each period having thus been set off against their relative figure of gross profit, the net profit made before and after the incorporation or commencement certificate will be ascertained.

It would be the auditor's duty to see that proper allocations are made in this behalf, and only the profits legitimately distributable are rendered available for distribution.

LOSS PRIOR TO INCORPORATION OR COMMENCEMENT CERTIFICATE

If a company buys over a running business before the date of its registration and a loss is incurred prior to the date of Incorporation or the date of Commencement Certificate, such loss should be capitalised by adding it to the amount of Goodwill paid on the purchase of business, or if no Goodwill is paid for, by debiting the amount to Goodwill Account. If it is not desired to capitalise the loss, then the amount should be left on a Suspense Account, which should be written off out of profits of a capital nature e.g. Premium on Shares, Profit on Forfeited Shares, or Premium on Issue of Debentures etc.

RESERVE FUND

In some companies, the Articles provide for a certain sum or a percentage of the net profits to be credited to Reserve Fund, until the latter accumulates to a certain figure, prior to distribution of the profits each year. In such a case, the auditor should see that the requirements under the Articles are duly fulfilled. Where the directors are given discretion under the Articles to place any sum as they deem fit to Reserve Fund before recommending the payment of a dividend, such a power can be exercised by them even if it results in preventing payment of any dividend. But in so doing, they must act honestly and in the best interests of the company.

It is not desirable to credit exceptional profits of a capital nature such as Premium on Shares or Debentures, or credit balance on Forfeited Shares Account (left after the re-issue of Forfeited Shares) to Reserve Fund, although there is nothing to prevent a company legally from doing so, unless its own Articles forbid such a practice. Such capital or exceptional profit can be better utilised in writing off fictitious assets, if any, existing in the books, or in reducing or writing off Goodwill Account.

Where a Sinking Fund has been provided for the Redemption of Debentures, the credit balance on such Fund left after the actual redemption of debentures can be transferred to the Reserve Fund.

Where the directors decide to write up the value of any fixed asset as the result of a revaluation, the corresponding credit should be given to a Capital Reserve and not to Reserve Fund. Before passing such entries relating to appreciation of any assets, the auditor must try to ascertain the motive behind this move and satisfy himself that the revaluation has been made by proper experts. Under no circumstance should he allow such an excess to be taken credit for in the Profit and Loss Account. There is nothing wrong, however, in utilising a *bona fide* excess arising from the revaluation of fixed assets in wiping off a previous debit balance on the Profit and Loss Account so that dividends may be paid out of current profits.

An existing Reserve Fund may be drawn upon for equalising dividends or for meeting exceptional losses.

POSITION OF PREFERENCE SHAREHOLDERS

Where different classes of shares are issued, the rights of the respective shareholders are generally governed by the Memorandum and the Articles. As a rule, the Preference Shares carry a fixed dividend out of the profits in priority to the Ordinary Shares which would be entitled to the balance of the divisible profits. Preference Shareholders are not entitled to a return of their capital in priority to any refund to the Ordinary Shareholders in the event of liquidation, unless the Articles expressly provide that the Preference Shares are to be preferential as to capital. In the absence of such a provision, Preference Shares rank equally with the Ordinary Shares in regard to return of Capital. Further, it should be seen if the right of the Preference Shareholders to dividend is cumulative. In the absence of any express provision in the Articles to the contrary, all Preference Shares carry a right to Cumulative Dividend. Where the Preference Shares are entitled to a preferential dividend at a specified rate per cent, such dividend is *prima facie* cumulative; but where the Articles state that such dividend is to be paid out of the profits of "each year", the right of the Preference Shareholders to dividend will be deemed to be non-cumulative.

In the absence of any express power in the Articles authorising the directors to declare the dividends upon the Preference Shares provided the company has made sufficient profits to justify such a declaration, preference dividends can only be declared by the shareholders in general meeting just like dividends upon Ordinary Shares.

Preference Shareholders cannot as a matter of right prevent the directors from applying the profits of the current year towards making good previous losses or from transferring the profits to such reserve as the directors may deem fit in the best interests of the company.

In case of liquidation, the question as to whether the Preference Shareholders can participate in a surplus left after the repayment of the whole of the share capital must necessarily depend on the terms of issue and the provisions in the Memorandum and the Articles defining the rights of the different classes of shareholders. There have been many conflicting decisions on this point and no hard and fast rules can be laid down in the matter. If the surplus be attributable to profits, and if the Preference Shareholders have already received all their dividends, such surplus would belong to the Ordinary Shareholders, in the absence of anything to the contrary in the company's regulations.

It would seem, however, that a preference given either in respect of dividend or refund of capital or both will not of itself act as a bar to prevent the preference shareholders from claiming a share out of such surplus. In other words, unless the Articles provide otherwise, the holders of preference shares having the right of priority as to refund of capital would share rateably with the ordinary shareholders in any surplus left after the latter have been repaid their capital in full, in a winding-up.

Unless there is a contrary provision in the Articles, Cumulative Preference Shareholders are not entitled to be paid the arrears of dividends from the surplus, if the dividends were not declared before the winding-up.

PRIVATE COMPANIES

A Private Company is defined by Section 2 (1) 13 as under:—

‘Private Company’ means a company which by its articles—

- (a) restricts the right to transfer the shares, if any; and
- (b) limits the numbers of its members to fifty not including persons who are in the employment of the company; and
- (c) prohibits any invitation to the public to subscribe for the shares, if any, or debentures of the company:

Provided that where two or more persons hold one or more shares in a company jointly they shall, for the purposes of this definition; be treated as a single member.

Private Companies enjoy many privileges by way of exemption from several restrictions and obligations to which public companies are open. The following are the important exemptions:—

- (1) Restrictions on appointment of first directors (Section 84).
- (2) Restrictions on the first allotment of shares (Section 101).
- (3) Restrictions on commencement of business (Section 103).
- (4) Holding of Statutory Meeting, and of circulating and filing the Statutory Report (Section 77).
- (5) Circulation of Annual Balance Sheet and Profit and Loss Account and Auditor's Report amongst its members (Section 131).
- (6) Filing of Annual Balance Sheet and Profit and Loss Account with the Registrar (Section 134).
- (7) The auditor need not be a Registered Accountant [Section 144(1)].
- (8) Limit on number of directors to be appointed by managing agents (Section 87I).
- (9) Provisions as to making of loans or guaranteeing loans to directors (Section 86D).
- (10) Restrictions on powers of directors in regard to disposing of the undertaking of the company, or remitting debt due by a director (Section 86H).
- (11) Restrictions as to duration of appointment of managing agents (Section 87A).
- (12) Provisions as to remuneration of managing agents (Section 87C).
- (13) Restriction on Loans to managing agents (Section 87D).
- (14) Prohibition of voting by interested directors (Section 91B).

NOTE.—A Private Company, which is a subsidiary of a Public Company, does not enjoy a majority of the above privileges to which other private companies are entitled.

RESOLUTIONS OF SHAREHOLDERS

The transactions by the shareholders are always effected by means of Resolutions at meetings. The annual general meeting of the company is known as the ordinary general meeting, and all meetings other than this are called extraordinary meetings. The resolutions are of three kinds:—

- (1) Ordinary.
- (2) Extraordinary.
- (3) Special.

An **ORDINARY RESOLUTION** is one which is passed by a bare majority of those present and voting personally or by proxy at any of the Ordinary General Meeting of which 14 days' notice has been given.

An **EXTRAORDINARY RESOLUTION** is one which has been passed by a majority of not less than three-fourths of members entitled to vote and present in person or by proxy (where proxies are allowed) at a general meeting of which 14 days' notice specifying the intention to propose the resolution as an extraordinary resolution has been duly given.

A **SPECIAL RESOLUTION** is one which is passed by a majority as required in case of an extraordinary resolution, at a general meeting of which not less than 21 DAYS' NOTICE specifying the intention to propose the resolution as a special resolution has been duly given.

The business usually transacted by means of an Ordinary Resolution is:—

- (a) Adopting the Statutory Report (Section 77).
- (b) Adopting the Balance Sheet and Accounts at the Annual General Meeting (Section 131).
- (c) Appointing Directors (Section 83B).
- (d) Electing Auditors and fixing their remuneration (Section 144).
- (e) Declaring Dividends and sanctioning the sums to be carried to Reserves (Clause 95—Table A).
- (f) Permitting a director or his firm to hold an office of profit (Section 86E).
- (g) Appointing a director in place of one removed (Section 86G).
- (h) Appointing or removing the managing agent, or varying the contract of management (Section 87R).
- (i) Authorising issue of Shares at a discount (Section 105A).
- (j) Agreeing to sell or dispose of the undertaking of the company, or to remit any debt due by a director (Section 86H).
- (k) Authorising representatives to inspect the books of a subsidiary company [Section 132A (5)].

The following would require an Extraordinary Resolution:—

- (a) Removal of a Director (Section 86G).
- (b) Winding up a company, when it cannot by reason of its liabilities continue its business [Section 203 (3)].
- (c) Disposing the books and documents of the company in a voluntary winding up (Section 242).

The following business would require a Special Resolution:—

- (a) Altering or adding to the Company's Articles of Association (Section 20).
- (b) Altering the name of the company (Section 11).
- (c) Re-organizing of the Share Capital (Section 54).
- (d) Reducing the Share Capital (Section 55).
- (e) Sanctioning additional remuneration to Managing Agents [Section 87C (2)].
- (f) Sanctioning payment of Interest out of Capital during construction (Section 107).
- (g) Appointment of inspectors to investigate the company's affairs (Section 142).
- (h) Winding up the company without assigning any reason [Section 203 (2)].

Extraordinary Meetings may be convened either by the director on their own initiative or on requisition as required by Section 78, as under:—

Notwithstanding anything in the Articles, the directors of a company must, on the requisition of the holders of not less than one-tenth of the issued share capital of the company upon which all calls or other sums then due have been paid, forthwith proceed to call an extraordinary general meeting of the company. The requisition must state the objects of the meeting and must be signed by the requisitionists and deposited at the registered office of the company. If the directors do not convene a meeting within twenty-one days, the requisitionists may themselves do so.

Throughout the checking of any of the above transactions, the auditor's duty will be to satisfy himself that the resolutions passed for the purpose of sanctioning these transactions are as required by the Act, and have been duly recorded in the Shareholders' Minute Book.

FINANCIAL ASSISTANCE FOR PURCHASE OF ITS OWN SHARES

A company cannot purchase its own shares, for such a procedure will result in a reduction of capital, which cannot be carried out without the leave of the Court. Section 54A of the Act thus prohibits a company from applying any of its assets in buying its own shares or the shares of any public company of which it is a subsidiary, unless the provision for the reduction of capital is followed. It also makes it unlawful for a company even to give any financial assistance either directly or indirectly whether by means of a

loan, guarantee, provision for security or otherwise for the purpose of enabling any person to purchase its own shares. An exception, however, is made in the case of a company where the lending of money is part of the ordinary business of the company. This Section in no way affects the redemption of Redeemable Preference Shares by a company which can now be issued under Section 105 (B). If the auditor has any reason to believe that moneys are advanced by the company to any person to purchase its own shares, he should bring this fact to the knowledge of the shareholders.

Section 54A.—(1) No company limited by shares shall have power to buy its own shares or the shares of a public company of which it is a subsidiary company unless the consequent reduction of capital is effected and sanctioned in the manner provided by sections 55 to 66.

(2) No company limited by shares other than a private company, not being a subsidiary company of a public company, shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase made or to be made by any person of any shares in the company :

Provided that nothing in this section shall be taken to prohibit, where the lending of money is part of the ordinary business of a company, the lending of money by the company in the ordinary course of its business.

(3) If a company acts in contravention of this section, the company and every officer of the company who is knowingly and wilfully in default shall be liable to a fine not exceeding one thousand rupees.

(4) Nothing in this section shall affect the right of a company to redeem any shares issued under section 105(B).

INVESTMENT OF SECURITIES LODGED BY EMPLOYEES AND THOSE BELONGING TO PROVIDENT FUND

Section 282B is important as it seeks to prevent misuse of securities lodged with a company by its employees under contracts of service, and to safeguard Provident Funds. Under this Section, a statutory duty is cast upon a company to lodge all moneys and securities deposited with it by its own employees under contracts of service in a Scheduled Bank, and no portion thereof is to be utilized for any other purpose than as mentioned in the contracts of service. The Section further provides for the contributions to Provident Funds, if any, created for the employees, to be kept invested in Trust Securities as defined in Section 20 of the Indian Trusts Act.

Where securities or moneys are lodged by employees under any contract for service or where there exists a Provident Fund for the benefit of the employees, the auditor should see that the corresponding securities or moneys are banked or invested as required by statute.

Section 282B.—(1) All moneys or securities deposited with a company by its employees in pursuance of their contracts of service with the company shall be kept or deposited by the company in a special account to be opened by the company for the purpose in a scheduled bank as defined in clause (c) of section 2 of the Reserve Bank of India Act, 1934, and no portion thereof shall be utilised by the company except for the purposes agreed to in the contract of service.

(2) Where a provident fund has been constituted by a company for its employees or any class of its employees, all moneys contributed to such fund (whether by the company or by the employees) or accruing by way of interest or otherwise to such fund after the commencement of the Indian Companies (Amendment) Act, 1936, shall be invested, and shall be invested only in securities mentioned or referred to in clauses (a) to (e) of section 20 of the Indian Trusts Act, 1882, and all moneys belonging to such fund at the commencement of the said Act which are not so invested shall be invested in such securities by annual instalments not exceeding ten in number and not less in amount in any year than one-tenth of the whole amount of such moneys.

(3) Notwithstanding anything to the contrary in the rules of any funds to which sub-section (2) applies or in any contract between a company and its employees, no employee shall be entitled to receive in respect of such portion of the amount to his credit in such fund as is invested in accordance with the provisions of sub-section (2) interest at a rate exceeding the rate of interest yielded by such investment.

(4) An employee shall be entitled on request made in this behalf to the company to see the bank's receipt for any money or security such as is referred to in sub-section (1) and sub-section (2).

(5) Any director, managing agent, manager or other officer of the company who knowingly contravenes or permits or authorises the contravention of the provisions of this section shall be liable on conviction to a fine not exceeding five hundred rupees.

STATEMENT IN LIEU OF PROSPECTUS

No public company can proceed to allotment of shares without first filing a Prospectus or a Statement in lieu of Prospectus. Private Companies can proceed to allot shares without filing either a Prospectus or a Statement in lieu of Prospectus.

Section 98.—(1) A company which does not issue a prospectus on or with reference to its formation shall not allot any of its shares or debentures unless before the first allotment of either shares or debentures there has been filed with the registrar a statement in lieu of prospectus signed by every person who is named therein as a director or a proposed director of the company or by his agent authorised in writing, in the form and containing the particulars set out in the form marked 1 in the Second Schedule.

(2) This section shall not apply to a private company or to a company which has allotted any shares or debentures before the commencement of this Act or, in so far as it relates to the allotment of shares to a company limited by guarantee and not having a share capital.

COMPULSORY CLAUSES IN TABLE A

In regard to the regulations of Table A which must apply to all companies, as required under Section 17 of the Act, the auditor should see that the company's Articles do not contain any clauses in contravention of these.

RIGHTS OF PREFERENCE SHAREHOLDERS AND DEBENTURE-HOLDERS

Under Section 146, preference shareholders and debenture-holders of a public company have the same right to receive and inspect the Balance Sheets and Profit and Loss Accounts, and the Reports of the Auditors as is possessed by ordinary shareholders.

CHAPTER VIII

AUDITS OF HOLDING COMPANIES

Until the passing of the Indian Companies (Amendment) Act, 1936, there was practically no legal control over Holding Companies in India, with the result that their periodical Balance Sheets hardly disclosed to the investing public the true extent of their financial interests in their subsidiaries. The accounts as published by Holding Companies concealed as much as it suited their purpose or revealed as little as they wished. Under such a state of affairs, it was not possible for the shareholders to ascertain from the legal Balance Sheet either the true relation of the Holding Company to its subsidiaries or the profits arising from the holdings in other companies. This most unsatisfactory state of affairs is now brought to an end to some extent by the following provisions in the Indian Companies Act, 1936, which make the disclosure of certain particulars relating to the financial interests in the subsidiary companies compulsory for Holding Companies.

A Holding Company is one which holds either the whole of the share capital or a sufficient number of shares in one or more companies so as to secure a controlling interest in such companies, the latter being then known as "Subsidiary Companies". The object may be to eliminate competition, combine expert technical knowledge and experience, secure economy in production and management, monopolise sources of raw material supplies and control prices. Such a combination of separate enterprises can, no doubt, be brought about by the amalgamation and absorption of two or more companies into one, but in such a case, the companies which are being absorbed have to go into liquidation and thus lose their identity, and yet the trade name, reputation and goodwill of some may be worth continuing. If the subsidiary company happens to be located in a foreign country, it would be found desirable to run it as a separate legal entity in order that it may enjoy certain local rights or privileges which may not be accorded to foreign or non-domiciled companies. The incidence of taxation may be another important consideration to treat the foreign subsidiary as a distinct entity. This is exactly where the Holding Company System comes in useful: In the case of a Holding Company, whereas the Subsidiary Companies retain their identities and constitutions and carry on their businesses as if they were distinct entities, they are capable of being efficiently controlled in policy and management by the Parent Company due to the latter holding a majority of shares and the consequent voting power. Thus, it is by means of Holding Companies that a combination of separate businesses may be secured without any disturbance of the constituent businesses by the trade name or trade-mark of each Subsidiary Company being left intact and the best advantage being taken of the existing goodwill, if any, of each of the Subsidiary Companies. But, with all the advantages attendant upon economical management and control of market such combinations present possibilities for fraudulent pro-

motion and management, manipulations of inter-company transactions and presentation of trading results in a manner as would either obscure the true facts or fail to disclose to the shareholders the true value of their holdings.

Section 2.—Section 2(2) of the Act defines a Holding Company and a Subsidiary Company by their relation to each other as under :—

Where the assets of a company consist in whole or in part of shares in another company, whether held directly or through a nominee and whether that other company is a company within the meaning of this Act or not, and

- (a) the amount of the shares so held is at the time when the accounts of the holding company are made up more than fifty per cent of the issued share capital of that other company or such as to entitle the company to more than fifty per cent of the voting power in that other company, or
- (b) the company has power (not being power vested in it by virtue only of the provisions of a debenture trust deed or by virtue of shares issued to it for the purpose in pursuance of those provisions) directly or indirectly to appoint the majority of the directors of that other company,

that other company shall be deemed to be a subsidiary company within the meaning of this Act, and the expression 'subsidiary company' in this Act means a company in the case of which the conditions of this sub-section are satisfied and includes a subsidiary company of such company :

Provided that where a company, the ordinary business of which includes the lending of money, holds shares in another company as security only, no account shall, for the purpose of determining under this Section whether that other company is a subsidiary company, be taken of the shares so held.

SUBSIDIARY COMPANY

A company may thus be a "Subsidiary" of a Holding Company in any of the three cases, viz.:—

(1) Where the Holding Company holds more than 50 per cent of the issued share capital of the Subsidiary Company; or

(2) Where the Holding Company controls more than 50 per cent of the voting power of the subsidiary, even without having a corresponding holding in its share capital; or

(3) Where the Holding Company possesses the power directly or indirectly of appointing a majority of directors of that other company.

SECTION 132A

This is a new Section based on Section 126 of the English Companies Act, 1929, and is the principal enactment relating to Holding and Subsidiary Companies in India. The whole Section reads as under:—

Section 132A.—(1) Where a company, in this Act referred to as the holding company, holds shares, either directly or through a nominee, in a subsidiary company or in two or more subsidiary companies, there shall be annexed to the balance-sheet of the holding company the last audited balance-sheet, profit and loss account and auditors' report of the subsidiary company or companies, and a statement signed by the persons by whom, in pursuance of Section 133, the balance-sheet of the holding

company is signed stating how the profits and losses of the subsidiary company, or, where there are two or more subsidiary companies, the aggregate profits and losses of those companies, have been dealt with in or for the purposes of the accounts of the holding company, and in particular how and to what extent—

- (a) provision has been made for the losses of a subsidiary company either in the accounts of that company or of the holding company or of both, and
- (b) losses of a subsidiary company have been taken into account by the directors of the holding company in arriving at the profits and losses of the company as disclosed in its accounts :

Provided that it shall not be necessary to specify in any such statement the actual amount of the profits or losses of any subsidiary company or the actual amount of any part of any such profits or losses which has been dealt with in any particular manner :

Provided further that for the purposes of this section an investment company, that is to say, a company whose principal business is the acquisition and holding of shares, stocks, debentures or other securities, shall not be deemed to be a holding company by reason only that part of its assets consists in 51 per cent or more of the shares of another company.

(2) if, in the case of a subsidiary company, the auditors' report on the balance-sheet of the company does not state without qualification that the auditors have obtained all the information and explanations they have required and that the balance-sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them and as shown by the books of the company, the statement, which is to be annexed as aforesaid to the balance-sheet of the holding company, shall contain particulars of the manner in which the report is qualified.

(3) For the purposes of this section the profits or losses of a subsidiary company mean the profits or losses shown in any accounts of the subsidiary company made up to a date within the period to which the accounts of the holding company relate, or, if there are no such accounts of the subsidiary company available at the time when the accounts of the holding company are made up, the profits or losses shown in the last previous accounts of the subsidiary company which became available within that period.

(4) If for any reason the directors of the holding company are unable to obtain such information as is necessary for the preparation of the statement aforesaid, the directors who sign the balance-sheet shall so report in writing and their report shall be annexed to the balance-sheet in lieu of the statement.

(5) The holding company may by a resolution authorise representatives named in the resolution to inspect the books of account kept in accordance with Section 130 by any subsidiary company, and on such resolution being passed, those books of account shall be open to inspection by those representatives at any time during business hours.

(6) The rights conferred by Section 138 upon members of a company may be exercised in respect of any subsidiary company by members of the holding company as if they were members of that subsidiary company.

The provisions of the above Section may briefly be summarised as under:—

- (a) If a Holding Company holds shares in one or more subsidiary companies, there should be attached to the Balance Sheet of the

Holding Company, the last audited Balance Sheet, Profit and Loss Account and Auditors' Report of each Subsidiary Company;

- (b) There should be also a statement signed by the same person who signed the Balance Sheet of the Holding Company specifying how the profits or losses of the subsidiary company or the aggregate profits or losses of the subsidiaries have been dealt with in the accounts of the Holding Company;
- (c) Such statement should particularly specify how and to what extent, losses, if any, of the subsidiaries, have been provided for or brought into account in the Holding Company's accounts;
- (d) For the purpose of inclusion of the statements of profits and losses relating to Subsidiary Companies, the Profit and Loss Accounts of the Subsidiaries must be made up to a date within the period to which the accounts of the Holding Company relate;
- (e) If the auditor's Report on the Balance Sheet of any subsidiary company is qualified, the statement abovesaid must contain particulars of such qualification;
- (f) The Holding Company may, by a special resolution, authorise its representatives to inspect the books of account of any of its subsidiaries;
- (g) The Holding Company may exercise the rights (conferred by Section 138) of appealing to the Local Government for having the affairs of any of its Subsidiary Companies investigated;
- (h) If any of the information compulsorily required to be attached to the Holding Company's Balance Sheet as abovesaid is not available, the directors of the Holding Company must make a report to that effect in writing and attach the same to their Balance Sheet.

An Investment Company whose principal business is the holding of shares, stocks, debentures or other securities will not be deemed to be Holding Company for the simple reason that part of its assets consists of 51 per cent or more of the shares of another company.

REQUIREMENTS OF FORM F

In the prescribed form of Balance Sheet as per the new Form F, the Holding Company's position in relation to its subsidiary companies is required to be shown in distinct details. The following items will thus need to be specifically shown:—

ON THE ASSETS SIDE

- (a) The aggregate amount of Loans to Subsidiary Companies.
- (b) The aggregate amount of Investments in Shares or Debentures of Subsidiary Companies.

ON THE LIABILITIES SIDE

- (a) The aggregate amount of liabilities owing to Subsidiary Companies.

ACCOUNTS OF SUBSIDIARY COMPANIES

It should be noted that a subsidiary company, being a self-contained legal unit, must prepare and publish its own annual accounts, and have the same audited and placed before its shareholders in general meeting in the usual way, without reference to the control by the holding company. It is on the holding companies that strict legal obligations are imposed requiring them to make detailed disclosures in their own Balance Sheet in respect of their financial position with each of their subsidiaries and also as to the profits or losses of the subsidiaries.

SUPPLEMENTAL INFORMATION RELATING TO SUBSIDIARIES

Although the Amending Act calls for presentation of greater details to the shareholders of the Holding Company than were available to them prior to the Act, yet the whole of the facts relating to the holdings in subsidiaries are not required to be disclosed in a manner as would enable the members of the Holding Company to ascertain the real value and true relationship of each subsidiary to its Parent Company. The circulation of a separate Balance Sheet of each of its subsidiaries by the Holding Company together with its own Balance Sheet amongst its shareholders can only have any practical value where the subsidiary companies are few in number. Moreover, the Balance Sheet periods of subsidiary companies may not coincide with the Holding Company's financial period, and complicated adjustments would, therefore, become necessary in order to arrive at a fair and reliable position of the assets and liabilities on the date of presentation, and these may not be properly understood by the shareholders.

In order, therefore, to satisfy the legitimate demands on the part of their members to place before them a more detailed and intelligible statement pertaining to the group of companies which it controls so as to enable them to obtain a clear view of the financial position and progress of the concern as a whole, a large number of Holding Companies now attach a Consolidated Balance Sheet to their own legal Balance Sheet wherein the assets and liabilities of all their subsidiaries are presented in a summarised form along with their own. Besides, in view of the fact that the main object of the Holding Company system is to exercise control over its subsidiaries, it is highly essential that those in management should have placed before them, at periodical intervals, consolidated statements reflecting the true working results as also the financial position of the combine as a whole, and a Consolidated Balance Sheet serves a very useful purpose in this direction. It must be distinctly understood, however, that a Consolidated Balance Sheet is not a legal necessity, but is a mere supplementary statement in which the

assets and liabilities of all the subsidiaries are assimilated by the Parent Company just like a Head Office incorporating the assets and liabilities of its branches. Such a Balance Sheet is prepared in order that the Holding Company's position may be presented in greater details and would be more readily understood than the separate Balance Sheet of each of the subsidiaries.

SPECIAL POINTS ON PREPARATION OF CONSOLIDATED BALANCE SHEET

As several peculiar and complicated problems arise in the preparation of a Consolidated Balance Sheet, and as the services of public accountants are usually requisitioned for the proper construction of such a statement, it has been thought desirable to place the following few hints for the benefit of the reader:—

(a) To enable a Consolidated Balance Sheet to be prepared, it is highly essential that the Balance Sheets of all the Companies must be made upto the same date, and all the assets and liabilities should be classified and valued on some uniform basis.

(b) Where the Balance Sheet of any subsidiary company is made upto a date different from the date of the Holding Company's Balance Sheet, proper adjustments must be made to enable the exact position of that subsidiary company to be ascertained as at the date of presentation.

(c) Where the Holding Company does not own the whole of the share capital of the subsidiary company, the interest of the outside shareholders should be brought into account while preparing a Consolidated Balance Sheet.

(d) Even where the Holding Company owns a PART only of the share capital of its subsidiary, the WHOLE of the assets, liabilities, reserves and gains or losses of the latter Company are embodied in the Consolidated Balance Sheet, and the net proportion of these applicable to the outside shareholders is then included as a liability. It need hardly be pointed out, in this connection, that if there appears on the Consolidated Balance Sheet the whole of the assets and liabilities of the subsidiaries, which are not totally owned by the Holding Company, there must also appear in the same Balance Sheet, the interest of the shareholders outside the combine, as a liability.

(e) The proportion of interest of the outside shareholders (assuming the issue to be in ordinary shares) will in such a case be represented by the nominal value of the share capital held by them, a proportionate share of the Capital Reserve representing undistributed profits, if any, as at the date of purchase, and a like proportion of the profit or loss made subsequent to the acquisition of controlling interest by the Holding Company. Where, however, the outside shareholders hold Preference Shares which do not participate in surplus assets, their interest in the Company will be measured by the nominal value of the Preference Shares held by them.

(f) Any indebtedness by one Company to another should not be shown in the Consolidated Balance Sheet.

(g) Bills drawn by the Holding Company and accepted by any of the subsidiaries and unmatured will be shown in their respective Balance Sheets as Bills Receivable and Bills Payable, but will be eliminated from the Consolidated Balance Sheet.

(h) Unrealised profits from inter-company transactions should be eliminated.

(i) Where inter-company transactions of purchases and sales of goods have taken place, and if such goods have not been sold off by the purchasing company, the selling company must write back the profit taken on these goods, as such profit cannot be said to have been realised from the view-point of the combine as a whole. Where, however, some of the shares of the selling company are held by outside shareholders, the profit on unsold goods to be written back will be in proportion to the shares held by the Holding Company.

(j) Only dividends paid by subsidiary companies from the profits made subsequent to the purchase of their shares should be credited to Profit and Loss Account.

(k) If the Holding Company receives any dividend from a subsidiary company out of Reserves or the Profit and Loss Account balance existing at the date of purchase of the controlling interest, the same should not be credited to Profit and Loss Account, but should be deducted from the purchase price of the shares acquired.

(l) On a Holding Company acquiring a block of shares in a subsidiary, if there happen to be any undistributed profits in the books of the subsidiary, the proportion of such profits belonging to the Holding Company should be treated as capital profits and utilised in reducing the purchase consideration paid.

(m) Where the Holding Company has bought shares of the subsidiary CUM DIVIDEND, any dividend it receives out of profits earned prior to acquisition of such shares should be credited to such Investment Account and not to the Profit and Loss Account.

(n) Where the subsidiary company has made losses prior to the purchase of its shares by the Holding Company, such fact must necessarily have been considered in arriving at the purchase price. On receipt of a first dividend from such company, therefore, the whole amount must be credited to Profit and Loss Account, as the same must necessarily have been declared out of Profits made subsequent to the purchase of its shares.

(o) Where the year out of the profits of which a dividend is declared by the subsidiary represents partly a period prior to the purchase of its shares and partly after the purchase, an apportionment of such dividend will become

necessary. The amount of dividend relating to the period prior to the acquisition of the shares will have to be treated as a capital gain and the balance as profit by the Holding Company.

(p) Profits of subsidiary companies should not be made available as dividends by the Holding Company, unless these have been actually distributed as dividends by the subsidiaries.

(q) Ordinarily, the shares in subsidiary companies should be valued at the actual cost. Where, however, the shares have depreciated in value due to a loss made by the subsidiary company, the value of shares should be adjusted accordingly. In other words, where a subsidiary company makes losses subsequent to the acquisition, a reserve therefor should be made in the Holding Company's Accounts from its own profits and deducted from the investment relating to its holding in the Balance Sheet.

(r) Where a loss is made by a subsidiary, but the values of the shares in other subsidiaries have appreciated, no reserve need be made to provide for the depreciation in value of the shares in the former company, but the appreciation in value of the shares of some subsidiaries may be set off against the depreciation in that of others.

(s) The item "Goodwill" will include the total value of Goodwill as ascertained from the Balance Sheets of all the companies in the holding group, as also any Premium paid by the Holding Company while acquiring shares in the subsidiaries. From the total of Goodwill thus ascertained, there will be deducted the total of Reserves and other Undistributed Profits existing in the books of the subsidiaries at the date of purchase of their shares.

(t) Where the shares in any subsidiary company are acquired at less than their nominal value, the discount thus arising will be deducted from the value of Goodwill.

(u) Where there happens to be a deficiency of assets in any subsidiary at the date of purchase, the same should be added to Goodwill.

AUDIT OF HOLDING COMPANIES

The Act has not imposed any additional duties on Auditors of Holding Companies in connection with the legal Balance Sheet and Profit and Loss Account, beyond what is usual and necessary in case of audits of other companies. The auditor should vouch the whole of the transactions with due care and diligence and see that they are *bona fide* and duly authenticated. He should devote particular attention to the verification of inter-company transactions, see to the proper grouping, classification and valuation of the assets and liabilities, the specific disclosure of the shareholdings in and the indebtedness to and from the subsidiaries, and the mode of valuation in the Balance Sheet as required by the Act. He should satisfy himself that the profits and losses of the subsidiaries have been duly brought into account on a fair and consistent basis. He should particularly enquire

whether or not the Holding Company has sufficiently provided for the losses, if any, sustained by any of the subsidiaries. Finally, he should satisfy himself that the Balance Sheet on which he sets his signature and report does truly represent the correct view of the state of affairs of the company. If he is not satisfied on any account, and has failed to obtain revision of accounts from those responsible in accordance with his wishes, he should not refrain from making a pointed reference to the facts in his report to the shareholders whose interests he is always supposed to watch.

The basis of valuation of the shares in the Subsidiary Companies possessed by a Holding Company must be very carefully looked into by the auditor. The Holding Company would have acquired such shares with a permanent object, and since such an Investment in its case would be a fixed asset, it would not be legally compulsory for it to provide for depreciation in the value of its holdings in the Associated or Subsidiary Companies.

A sound and prudent policy even in case of Holding Companies would, however, be to value the shares of the Subsidiary Companies at market price, if the same is lower than the cost. Where the shares of the Subsidiary Companies are quoted on the Stock Exchange there will be no difficulty in ascertaining their market values. Where, however, there is no quotation for such shares, it will be necessary for the auditor to examine the Balance Sheets of the Associated Companies in order to ascertain the then true values of such shares. If on such examination, he finds that as a result of losses, the present financial condition of some companies is worse than what it was at the time the Holding Company had acquired their shares, then such shares should be written down to that extent. Where the Subsidiary Companies are better financially situated than at the time the Holding Company had acquired their shares, such holdings should be valued at cost price. The auditor will naturally consult the Holding Company's Memorandum and Articles to see if they require any particular mode of valuation of the shares of the Subsidiary Companies to be followed, for if so, such method will have to be scrupulously adhered to. If the auditor finds on a careful consideration of all the facts before him that the true position of the Holding Company is not clearly presented to its shareholders, he should insist on the same being done by the Directors, and if they refuse, he should mention these facts in his audit report. He should further see that the Investments in and Loans to and from the Subsidiary Companies are shown distinctly in the Holding Company's Balance Sheet, and are not mixed up with other investments.

It is not for the auditor to insist on a Consolidated Balance Sheet being presented by the directors to the shareholders nor is he responsible for the preparation of such a statement. If, however, he is called upon to audit and report on the consolidated statement, he should do so after fully satisfying himself that the same has been constructed on sound and correct principles, that all the necessary adjustments have been made, and that the statement presents a true picture of the whole group of companies.

He is not supposed to check and certify the statement which is compulsorily required to be annexed to the Balance Sheet and signed by the directors stating how the profits or losses of the subsidiaries have been dealt with in the accounts of the holding company. In order that the auditor's report may not be taken to cover such a statement by the directors, it seems necessary and desirable that the latter should appear below his signature and report to the members.

It needs to be mentioned that for a true presentation of the financial condition of the whole of the undertaking on any one date in shape of a Consolidated Balance Sheet, it seems fundamentally necessary that the financial periods of the Holding Company as also of each of its subsidiaries should be made to coincide. The Amending Act does not contain any provision to this effect nor does it require the compulsory publication of a Consolidated Balance Sheet. Further, experience has shown that even a Consolidated Balance Sheet does not serve the purpose of giving to the shareholders the fullest disclosures in regard to the true earning capacity of the undertaking as a whole, unless it is accompanied by a Consolidated Statement of Profits and Losses for the same period. A question thus arises whether it would not be deemed desirable in the future to take the Act a step further and make it compulsory for every Holding Company to attach the above two statements (a Consolidated Balance Sheet and a Consolidated Statement of Profits and Losses) to its legal Balance Sheet along with the Balance Sheet of each of the subsidiaries. A further legal provision making it compulsory for the Holding Company as also for its subsidiaries to present accounts for the financial periods ending on the same date would prove of immense value and benefit to the investing public.

CHAPTER IX

RIGHTS, DUTIES AND LIABILITIES OF AUDITORS

The question as to how far an auditor is liable for any errors or defalcations that he may have failed to detect in the accounts audited by him is very difficult and complex. Ordinarily, however, it seems that an auditor would be held responsible for any loss his clients may suffer due to errors or fraud left undetected by reason of his negligence, and he would be called upon to make good any damage resulting from such negligence.

AUDITOR TO A PARTNERSHIP FIRM

The responsibilities of an auditor are none the less onerous in case of an audit of a sole trader or a partnership firm. While preparing or certifying accounts on behalf of clients, the auditor should always keep in view the chances of such accounts being used as a basis of negotiation with third parties without his knowledge, either for the purpose of borrowing a loan from the bankers, or satisfying the creditors or bankers as to the financial condition of the business, or for securing a new partner, or for presenting accounts for income-tax assessment. Thus, if he certifies any statement of account as correct, and if any third party such as a person entering into partnership or a banker advancing money relies upon such a certificate, it is very likely that he would expect the accounts to be accurate as if the audit had been done under instructions from him, and would seek to hold the auditor liable for any damages he might suffer, if the certified accounts are afterwards found to be wrong or misleading. It would seem, however, that in the absence of any fraud on the part of an auditor, such a third party cannot hold him liable in damages for negligence, as the auditor would owe no duty to him.

In case of a partial audit, the auditor should always take care to qualify his certificate clearly indicating the portion of work checked by him and limiting the responsibility undertaken. He should further see for his own protection that the precise terms of the agreement with his clients are set down in writing, and the limitations of responsibility undertaken by him are clearly defined therein. It is equally essential for him, whenever he certifies any statement of accounts, to report on such matters as would need elucidation for a proper understanding of any of the items therein, and to give a reference to such report on the face of the accounts.

Another question that an auditor has to face in professional practice is "How far is it his duty to enquire into the work of his predecessor?" Ordinarily, an auditor would not concern himself with the work of his predecessor. Very likely, it would seem to be his duty to communicate with his predecessor, and to enquire into the cause for the change before accepting the appointment. He should equally ascertain the reason for the change from his clients. He might also find it advantageous to enquire as to the scope

of the work previously done, in order to enable him to ascertain if there were any loopholes for fraud left open in such work, so that he may guard himself against these. In the absence of any ground for suspicion, he would assume that the accounts signed by his predecessor are correct. He would, of course, see that the opening entries in the books for the current period are in accord with the previous Balance Sheet. Should he, however, discover errors of principle or some other serious discrepancies made in the previous period and left undetected and which should necessarily be rectified in the current period, or that the previous work was performed in such a negligent manner as would burden the business with a loss in the period under review, it would certainly become his duty to bring this matter to the notice of his clients. The auditor should, under such a circumstance, get the fullest possible explanation on such points from his predecessor and weigh the whole of the facts most carefully before rushing into making a report to his clients.

While investigating accounts for a client, the auditor may discover irregularities of a serious nature on the part of an employee enjoying a high position or someone more closely associated with the client, such as the client's partner or relative, and under such a circumstance, his position would become very delicate. In any case, in the strict performance of his duties, he should lay aside all other considerations and must not seek for any other alternative but to report unhesitatingly his discoveries to his client.

In course of his professional career, an auditor would be entrusted with the most intimate financial affairs of his clients, and it is his duty to treat these in strictest confidence. Any disclosure of such matters from the auditor's office would not only cause annoyance to the client but might result in serious injury to the client's interests, for which liability in damages might arise. The Auditor and his staff are thus pledged to strictest secrecy, and bearing this in mind, it is highly essential for the principals to strongly impress upon their clerks the great necessity of never revealing the names of the clients to any one outside the office or allowing themselves to be drawn into a discussion concerning the business affairs of their principals or clients.

AUDITOR'S CERTIFICATE

When the auditor has completed the audit of a sole trader's business or of a partnership firm to his entire satisfaction, he must certify the Final Accounts as correct. Usually, such a certificate is appended at the foot of the Balance Sheet. There is no specific legal form required in such a case, but the following wordings will usually suffice:—

“Pursuant to the instructions as conveyed in your letter dated....., I have examined the books of account of your above firm with the relative vouchers and documents, and have obtained all the information and explanations which I have required. The above Balance Sheet and Profit and Loss Account have been drawn out in accordance with your

books and vouchers, and in my opinion, represent a true and correct view of the financial state of your business, according to the best of my knowledge and the explanations and information given to me."

The above form may be used with any modifications as circumstances would necessitate.

Where only a partial audit has been performed, or the financial records have been found in an incomplete state, or the vouchers produced and the explanations given are not satisfactory, the auditor should not hesitate to submit a detailed report on the matters in respect of which he is not satisfied. He should clearly point out in his report how far the complete verification of the books has suffered due to either a partial audit only having been conducted, or due to the incompleteness of the records or for want of supporting vouchers or other information. Besides, there might also be other matters which the auditor may want to place on record in order to clear his own position. Under such a circumstance, inasmuch as the report cannot be conveniently accommodated at the foot of the Balance Sheet, it is usual to issue it as a separate document, with a statement on the face of the Balance Sheet signed by him to the following effect:—

"The above Balance Sheet and Profit and Loss Account should be read in conjunction with my separate report of even date, which is attached herewith."

Such a reference to the report is absolutely necessary for the information and guidance of the clients as also of third parties before whom the audited accounts may be produced.

Further, if the auditor's services have been requisitioned for any specific purpose, he must be equally careful to recite in his report the purpose of the audit as held out to him by his client, and state in clear terms the extent to which he has verified the book entries, so as to safeguard his own position. It may happen that the certified accounts alleged to have been necessitated for Income-tax purposes may be utilised by the client for the purpose of securing a loan or for presentation to a prospective partner or for the sale of the entire business. In such a case, especially where the investigation has not been a complete one, the auditor cannot evade his responsibility by avoiding giving any report and merely signing the accounts, for the very fact that the accounts have been signed by a qualified professional accountant would necessarily lead any one reading the accounts to believe that they have been properly prepared after due investigation, so as to represent an accurate state of affairs. The auditor's report, in any case, should be clear, concise and free from any ambiguity.

AUDITOR UNDER THE COMPANIES ACT

The section that most affects the auditors is Section 145, as it lays down their powers and duties.

Section 145. (1) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanation as may be necessary for the performance of the duties of the auditors.

(2) The auditors shall make a report to the members of the company on the accounts examined by them, and on every balance-sheet and profit and loss account laid before the company in general meeting during their tenure of office, and the report shall state :—

- (a) whether or not they have obtained all the information and explanations they have required ; and
- (b) whether or not in their opinion the balance-sheet and the profit and loss account referred to in the report are drawn up in conformity with the law ; and
- (c) whether or not such balance-sheet exhibits a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company ; and
- (d) whether in their opinion books of account have been kept by the company as required by Section 130.

(2A) Where any of the matters referred to in clauses (a), (b), (c) and (d) of sub-section (2) is answered in the negative or with a qualification, the report shall state the reason for such answer.

(3) In the case of a banking company, if the company has branch banks beyond the limits of India, it shall be sufficient if the auditor is allowed access to such copies of and extracts from the books and accounts of any such branch as have been transmitted to the head office of the company in British India.

(4) The auditors of a company shall be entitled to receive notice of and to attend any general meeting of the company at which any accounts which have been examined or reported on by them are to be laid before the company, and may make any statement or explanation they desire with respect to the accounts.

(5) If any auditors' report is made which does not comply with the requirements of this section, every auditor who is knowingly and wilfully a party to the default shall be punishable with fine which may extend to one hundred rupees.

RIGHTS OF THE AUDITOR

Under the above section, every Auditor of a company has a right of access at all times to the books and accounts and vouchers of the company, and he is entitled to require from the directors and officers of the company such information and explanations as may be necessary for the due performance of his duties.

The term "Books" would include not only the financial records, but also all the statutory, statistical and costing books and even the letter books. The term "Vouchers" means any documentary evidence such as bills, receipts, agreements, leases, conveyances, etc., and even correspondence that would corroborate and authenticate the transactions as entered in the books. "At all times" would mean at any time during business hours. The auditor has thus available to him the whole of the material from which the periodical statements have been prepared, for the purpose of his investigation and report.

The words "as shown by the books of the company" do not preclude the auditor from carrying his search outside the books. The auditor must take reasonable care to ascertain that the books themselves show the company's true position. This is clearly explained by the words "according to the best of our information and the explanations given to us."

Over and above his right of inspection of the books and documents, the auditor has the privilege to ask for information and explanation on matters pertaining to accounts and in respect of which he wants further elucidation in the proper discharge of his duties. It is left to his sole discretion as to on what particular points he should seek for further information or explanation beyond what he finds recorded in the books and vouchers produced to him. It is equally for him to decide whether any particular explanation given to him is satisfactory or otherwise.

It is the duty of the directors and managing agents to have all the financial transactions properly recorded and to have periodical Balance Sheet and Profit and Loss Account prepared therefrom and placed before the auditors. It is for them to decide in what form such accounts should be placed before the shareholders. The auditor has then to ensure after a careful scrutiny and verification that the items in the Profit and Loss Account are all properly described so as to present a clear and correct view of the transactions for the period under audit, and that the assets and liabilities as shown in the Balance Sheet did really exist and have been properly set forth and valued. If he finds any modifications in the accounts necessary, he has the right to invite the directors' attention thereto and point out the manner in which he requires the accounts to be altered, or ask for further information to be given on the face of the accounts, so that it may be possible for him to give a "clean" report.

Without the consent of the directors, the auditor has no authority personally to make any amendments in the accounts placed before him by the directors for audit, if they happen to be not in accordance with the Act or misleading in any direction. He cannot also enforce any alterations in accounts, however desirable and necessary they may be. If, however, the directors refuse to amend the accounts as desired by him, he has the right to point out in his report to the shareholders in what particulars the accounts are either misleading or fail to satisfy the Act.

Under the Amending Act, the auditor has the further right to receive notice of and attend the general meeting of the company at which the accounts examined and reported upon by him are laid, and to make any statement before the shareholders or give any explanation he may desire with respect to such accounts. This, however, is only a RIGHT, and the auditor need not necessarily attend the general meeting unless he chooses to do so. A great significance is, however, attached to this extra privilege, as it gives the auditor an opportunity of correcting any misleading information which any director might give in regard to the audited statements or on

3 matters arising out of the comments made by him in his report. It further enables him to place before the shareholders any material facts which might come to his knowledge after his having made the report and which he considers necessary to be brought to the notice of the shareholders whose interests he is there to serve.

It needs to be pointed out, however, that an auditor cannot seek to evade his responsibility of qualifying his report where necessary by giving a "clean" report, and then supplement the same by making verbal statements and giving oral explanations at the general meeting of the shareholders on matters that should have properly been embodied in his report.

RULES FOR PROFESSIONAL PROPRIETY

As a result of the powers conferred on the Governor General in Council to prescribe Rules relating to the granting, renewal and cancellation of Certificates, very extensive Rules, styled the Auditors' Certificates Rules, 1932, have been framed in consultation with the Indian Accountancy Board. Attached to these Rules is a list of acts and omissions by a Professional Auditor which are deemed to be breaches of professional propriety. As these directly affect the auditor in his professional practice, it has been thought necessary to embody them hereunder:—

(1) Placing of his professional services at the disposal of or entering into partnership with an unqualified person or persons in a position to obtain business of the nature in which public accountants engage by means which are not open to an accountant enrolled on the Register or to a holder of a restricted certificate granted by a Provincial Government entitling him to act as an auditor within a province.

(2) Allowing or agreeing to allow directly or indirectly participation by a lawyer, broker or other agent, other than a Registered Accountant or a holder of a restricted certificate or a *bona fide* employee, of the profits of his professional work, or accepting or agreeing to accept any part of the profits of the professional work of a lawyer, auctioneer, broker, or other agent, other than a Registered Accountant or a holder of a restricted certificate, or any commission or bonus therefrom.

(3) Accepting a position as auditor previously held by some other accountant without communicating with him.

(4) Accepting an appointment without first ascertaining from the company that the requirements of Section 144 (6) of the Indian Companies Act, 1913 (VII of 1913), have been duly complied with.

(5) Soliciting professional work directly or indirectly in person, by letter, by advertising in newspapers or periodicals, by placards, by the distribution of circulars, cards or handbills or by any other like means.

(6) Publishing or sanctioning the publication of expressions of thanks or appreciation from clients, or promoting in any way laudatory notices with regard to professional matters.

(7) Certifying any accounts, exhibits, statements, schedules, or other forms of accountancy work which have not been verified entirely under the personal supervision of himself, a member of his firm, a member of his staff, another Registered Accountant or a holder of restricted certificate.

(8) Giving estimates of future profits for publication in a prospectus or otherwise, or certifying for publication statements of average profits over a period of two or more years without at the same time stating the profits or losses for each year separately.

(9) Failure to keep the moneys of his clients in a separate banking account or banking accounts exclusively used for the purpose.

(10) Authorising any person in India who is neither a Registered Accountant nor a holder of a restricted certificate to sign on his behalf any balance sheet, profit and loss account, report or statement.

The above rules, no doubt, aim at preserving a very high standard of professional status for practising accountants and auditors, and the auditor who is out to occupy a position of honour and standing in the profession would feel it his duty to act always to the best of his conscience, with strictest sense of integrity and justice, and in the best interests of his clients. The foremost duty that he owes to his clients not to reveal their business secrets and not to utilise the information gleaned in course of professional work to any other purposes should not be lost sight of.

DUTIES OF THE AUDITOR

The auditor is required, under Section 145, to make a report to the members of the company on the accounts examined by him, and on every Balance Sheet signed by him, and he will have to state in his report the following:—

(a) Whether or not he has obtained all the information and the explanations he had required;

(b) Whether, in his opinion, the Balance Sheet and the Profit and Loss Account referred to in the report are drawn up in conformity with law;

(c) Whether such Balance Sheet exhibits a true and correct view of the state of the company's affairs according to the best of his information and the explanations given to him, and as shown by the books of the company; and

(d) Whether, in his opinion, the books of account have been properly kept by the company as required under Section 130.

In case of a Bank which has Branches outside India, the Auditor is entitled to rely on such copies of and extracts from the books and accounts as might have been transmitted by the Branches to the Head Office.

A fresh duty is thus imposed on the auditor by Section 145 to the effect that apart from expressing his opinion upon the correctness or other-

wise of the annual accounts, he has also to report to the shareholders whether in his opinion the books of account have been properly kept by the company or not.

The auditor is responsible for the correctness of the Profit and Loss Account to the same extent that he is responsible for the accuracy of the Balance Sheet, and it follows, therefore, that the Profit and Loss Account should receive equally close scrutiny at his hands. He should ascertain that it sets out all the expenses and the earnings under their appropriate heads as required by the Act, and the net resultant profit or loss is truly arrived at. It would be his duty to see that if there are any extraneous or casual items of gain brought into credit in order to augment the year's profits, such items are shown distinctly on the face of the accounts, and not mixed up with other items so as to give a false impression of the trading results.

As to the Profit and Loss Account, apart from the matters required to be embodied therein under Clause 107 of Table A, which is now made compulsory for all companies by Section 17, the auditor should see that the particulars specifically required to be included therein under Section 132 (3), in respect of the remuneration of the managing agents and the directors and the amount of depreciation have been duly shown.

Where the whole amount of any item of expenditure is not charged against the income of that year, but is distributed over a number of years and a portion thereof only is charged to the Profit and Loss Account, the auditor should see that the fact is clearly specified on the face of the Profit and Loss Account and the Balance Sheet giving reasons why such a procedure has been adopted, as required by Section 17 (2).

An Auditor is bound to verify the accuracy of the books and of the transactions recorded therein. With the expert knowledge of accounting and commercial law and routine that he is deemed to possess, and with his right of access to all the books, vouchers and documents, and his right to require from the directors of the company any information or explanation in connection with the accounts, and with the exercise of reasonable care, skill and vigilance in the proper performance of his duties, he is deemed to be able to detect any existing fraud or errors in the accounts he is called upon to audit. He cannot, however, be held liable for not tracking out ingenious and carefully laid schemes of fraud, in the absence of anything to arouse his suspicion, and when such frauds have been perpetrated by the trusted servants of the company.

He should thoroughly satisfy himself on an exhaustive scrutiny of the books that the whole of the transactions covering the period under audit have been duly entered, and that the Profit and Loss Account as well as the Balance Sheet reflect a true state of affairs of the business. He should ascertain that all the requirements of the I. C. Act in the preparation of both the final statements have been fully complied with. He should further determine after most careful enquiries that the securities and properties

shown in the Balance Sheet actually exist and that all the assets and liabilities have been duly incorporated and properly valued and exhibited under appropriate heads.

In the absence of any suspicious circumstances, he is entitled to rely on the representations, statements and opinions of technical experts and officials on matters outside his province. In regard to valuations of properties and other assets where specialised technical knowledge is required, he is entitled to rely on the certificates of those who are qualified by experience and qualification.

He must not allow any estimates or assumptions to creep into the accounts and must see that the statements he certifies are composed of facts and facts only. If, in course of his investigation, he comes across anything which arouses his suspicions, he must probe the matter to the bottom, and not rest till he has got at the facts.

In course of investigations, he is entitled to rely on the vouchers and documents presented to him by those in management unless he has reasons to believe that the tried servants of the company are dishonest. Throughout his work, he should act with reasonable care, skill and caution to ensure that no transaction is in any way illegal or improper, and if he discovers any such transaction, his duty will be to report the fact to the shareholders.

Where the auditor is thoroughly satisfied with the accuracy of the accounts he is signing, he will make the usual conventional report at the foot of the Balance Sheet above his signature, as under:—

I have audited the foregoing Balance Sheet of Co., Ltd., as at _____, and also the foregoing Profit and Loss Account of the Company for the year ended upon that date, and I report that :—

- (a) *I have obtained all the information and explanations I have required ;*
- (b) *in my opinion, the foregoing Balance Sheet and Profit and Loss Account are drawn up in conformity with the law ;*
- (c) *such Balance Sheet exhibits a true and correct view of the state of the Company's affairs according to the best of my information and the explanations given to me and as shown by the books of the Company ; and*
- (d) *in my opinion, books of account have been kept by the Company as required by Section 130 of the Indian Companies Act.*

If, however, the auditor is dissatisfied with the mode and manner of presentation of any of the items in the Balance Sheet or Profit and Loss Account, or if he thinks it necessary that the accounts presented by the directors call for further elucidation so as to give a correct view of the exact state of affairs, he should first place the whole matter before the directors and impress upon them the expediency of making the necessary modifications as would enable him to give the conventional report. The auditor should realise that any variation from the formal report must attract the

attention of the shareholders and the outside public and make them feel that there is something unusual or wrong and that he has, therefore, thought it fit to issue a qualified report. He should equally realise that he is there to safeguard the interests of the shareholders and should, therefore, refrain from doing anything whereby such interests would be prejudiced. Bearing this in mind, he should not rush into making a qualified report, unless he has fully and fairly discussed the points at variance with the directors and has given them every opportunity to make the necessary alterations in the Final Accounts, or give such additional information on the face of the accounts as he deems desirable. It is only when the directors have failed to see reason and fair-play that the auditor should resort to qualifying his report, and that too not till he has exhausted his best efforts to convince them of what is legally necessary. It is the auditor's vital duty to give the whole aspect of the situation a most careful and anxious consideration from all view-points before he finally decides upon making a qualified report. Above all, however, his statutory duty to the shareholders must be his primary consideration, and if he has thought it necessary in the faithful performance of such duties that nothing but a qualified report will meet the situation, he should unhesitatingly do so.

Where the auditor is unable to satisfy himself thoroughly as to the correctness of the Balance Sheet, or where his requirements are not complied with, he should specify in his report on what points he has not been satisfied or in what respect his requirements have not been complied with. This he should do in a very clear and unmistakable language and he should not try to protect himself by qualifying his report by means of vague expressions which fail to plainly indicate what he means to convey. He should never hesitate to bring to the notice of the shareholders any matters which are not apparent on the face of the accounts, and a suppression of which might cause a wrong view to be taken of the company's financial position.

The following are a few instances of qualifying clauses that an auditor might find necessary to insert in his report on the face of the accounts:—

(1) "The amount charged for depreciation on Plant and Machinery is, in my opinion, insufficient."

(2) "The Depreciation on Plant and Machinery, charged this year, is 5 per cent instead of $7\frac{1}{2}$ per cent as has been written off in previous years."

(3) "No Depreciation on fixed assets has been brought into account by those in management, on the ground that the whole of the company's assets have been efficiently maintained out of revenue."

(4) "The Lease Account continues to remain in the Balance Sheet at original cost, notwithstanding the fact that half of the term for which the lease had been acquired has expired."

(5) "In our opinion, the Reserve for Bad and Doubtful Debts is inadequate."

(6) "No provision has been made for Doubtful Debts in face of the fact that some of the debts are of old standing and statute-barred."

(7) "Included in the Book Debts are several accounts totalling up to Rs....., which represent goods sold for future delivery but not despatched."

(8) "The company's Investments have been valued at cost price, which is in excess of the present market value by Rs....."

(9) "The item 'Securities and Investments' includes 500 Ordinary Shares of Rs. 100 each in the Enterprise Limited, which is in liquidation."

(10) "The Stock-in-trade has been valued at market price, although the latter is higher than the cost."

(11) "The Work-in-progress figure has been verified with the statement certified by the Works Manager and the Managing Director, and includes a proportion of estimated profits on jobs nearing completion."

(12) "The Stock of Consignment to Rangoon has been included in the Accounts at cost price in spite of the fact that your company has not been able to obtain more than 75 per cent of such price in the case of the portion already sold."

(13) "The additional amount charged to Factory Building Account, in the current period, is in respect of the erection of the new engineering shed by the company's construction department, and the same has been taken as per the certificate of the company's Chief Engineer."

(14) "The accounts of the Calcutta Branch have been certified by the local auditors, and we have verified the proper incorporation of these in the Head Office books."

(15) "Included in the item of 'General Charges' is a sum of Rs....., paid to one of the Directors of the company for special services rendered by him in connection with the organization of the company's Rangoon Branch."

(16) "The shares held by your company in one of the Subsidiary Companies are included in the above Balance Sheet at cost, although the Profit and Loss Account of that company as last prepared, shows a debit balance of Rs. 1,20,000."

(17) "Included in the cost of Building and Plant and Machinery are sums of Rs. 7,500 and Rs. 12,000 respectively, in respect of the whole of the establishment and administration charges which relate to the period before the company entered into a revenue-earning stage."

When there are several points on which the auditor wishes to report to the shareholders, he should attach the report as a separate document and make a clear reference to this report on the face of the Balance Sheet as under:—

“The Balance Sheet and the Profit and Loss Account of the..... Company Ltd., above set forth and dated....., should be read in conjunction with my Report to the Shareholders dated.....attached herewith.”

From the above, it would be seen that the auditor's report ought to be outspoken, and that it ought not merely give hints, but must say what it means. Thus, it would not do for an auditor to state on the face of the Balance Sheet or in his report that “The value of the assets, as shown in the Balance Sheet, is dependent upon the realisation,” or that “The investments are stated at the same value at which they were included in the last Balance Sheet, without regard to fluctuations in value.” Such meaningless expressions would convey next to nothing to the shareholders, and the auditor who tries to word his report so as to be truthful and yet not offend the directors by conveying too much information to the shareholders would be deemed to have failed in his duty. If the auditor means to convey that in his opinion the assets are dangerously over-valued, or that the market value of the investments has fallen considerably and yet this depreciation in value is ignored in the Balance Sheet, he should state such a fact in a clear and unambiguous language.

LIABILITIES OF AN AUDITOR

ACTION FOR NEGLIGENCE

Ordinarily, an auditor is liable in damages to make good the loss his clients may suffer as a result of negligence on his part in the due performance of his duties. The commonest form of claim arises from the auditor having failed to detect defalcations or discover errors which may have put the company to loss. This liability, however, does not extend to third parties who may suffer loss through his negligence, as he is not employed by them and he owes them no duty. Where, however, there has been any fraud on the part of the auditor, he would be liable to third parties in tort, and may be sued by them. In any case, an honest auditor must fully realise and appreciate his moral obligations to third parties, and in view of the fact that the Final Accounts reported upon by him are likely to be relied upon and accepted by them without further enquiry, he will always use his utmost care and skill to see that the statements issued above his signature do reflect a true position of the accurate state of affairs and that they are free from ambiguity.

For a third party to hold an auditor liable for fraud, it is necessary to prove the following four facts against him:—

- (a) That the statement signed by him was untrue in fact;
- (b) That he knew that it was untrue or was culpably ignorant (i.e., recklessly or consciously ignorant) whether it was true or not;

(c) That the statement was made with the intent that the other party should act on it; and

(d) That the other party did act in reliance on it and suffered damage.

Section 235 of the Indian Companies Act, 1913, empowers the Court to assess damages against delinquent directors, managers or any officers of the Company, thus:—

Section 235. (1) Where, in the course of winding up a company it appears that any person who has taken part in the formation or promotion of the company, or any past or present director, manager or liquidator, or any officer of the company has misapplied or retained or become liable or accountable for any money or property of the company, or been guilty of any misfeasance or breach of trust in relation to the company, the Court may, on the application of the liquidator, or of any creditor or contributory made within three years from the date of the first appointment of a liquidator in the winding up or of the misapplication, retainer, misfeasance or breach of trust, as the case may be, whichever is longer, examine into the conduct of the promoter, director, manager, liquidator or officer, and compel him to repay or restore the money or property or any part thereof respectively with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust as the Court thinks just.

(2) This section shall apply notwithstanding that the offence is one for which the offender may be criminally responsible.

The auditor is included in the term “Officer” for the purposes of this Section.

Where an auditor, owing to want of skill and care certifies erroneous accounts, and if such neglect of duty on his part leads to an improper payment of dividend out of Capital, he can be held liable to make good the loss the company may have thus been made to suffer.

CRIMINAL LIABILITY OF AUDITORS

Section 282 of the Indian Companies Act, 1913, relates to the criminal liability of any person who wilfully makes a false statement in any report, return, certificate or balance sheet, thus:—

Section 282.—Whoever in any return, report, certificate, balance-sheet or other document, required by or for the purposes of any of the provisions of this Act, wilfully makes a statement false in any material particular, knowing it to be false, shall be punishable with imprisonment of either description for a term which may extend to three years, and shall also be liable to fine.

In order to sustain a prosecution against the auditor under this section, it must be proved:—

(a) that the statement complained of is false in material particular;

(b) that it has been made in any return, report, certificate, balance sheet or some other document required by or for the purposes of any of the provisions of this Act; and

(c) that it has been made wilfully knowing it to be false.

An auditor who certifies a balance sheet or a statement of profits knowing it to be false is criminally liable under the above section.

LEGAL DECISIONS AFFECTING AUDITORS

The following extracts from the comments made by the Judges while discussing the duties and liabilities of auditors in a few of the leading English Cases form very interesting and instructive reading, and must prove exceedingly useful to students and practitioners alike.

In the case of the *Leeds Estate Building and Investment Society Ltd. vs. Shepherd* (1887), it was held that an auditor who is negligent in the due performance of his duties is liable for damages.

In the course of his Judgment, Stirling J., said as follows:—

“It is the duty of the Auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the Balance Sheet, but to see that it is a true and accurate representation of the company's affairs. It is no excuse that the Auditor has not seen the Articles when he knows of their existence.”

The facts of the case are as follows. The Company went into voluntary liquidation and an action was brought by the Liquidator against the Directors, the Manager and the Auditor of the Company to hold them liable for certain sums paid out of Capital in respect of dividends and for fees and bonuses paid to the Directors and the Manager respectively.

It was provided by the Articles of the Company that upon the payment of dividends the Directors were to receive certain bonuses by way of fees based upon the dividends paid, but that neither the dividends nor the bonuses were to be paid except out of profits. It was further provided that the Auditor was to state whether in his opinion the Balance Sheet was a full and fair Balance Sheet, properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs.

Except in the year 1876, the Company had not made any profit, and it was discovered during the liquidation proceedings that the dividends and bonuses had been paid out of capital, and that the Balance Sheets were false and misleading and had been so framed as to render such dividends available.

The Balance Sheets were not shown to the Shareholders as required by the Articles. The Auditor was not furnished with a copy of the Articles, and did not therefore comply with their provisions. The Directors relied entirely upon the Auditor who had examined the accounts prepared by the Manager, and they did not know that such Balance Sheets were inaccurate.

The Court held that the Directors were liable to make good the several sums paid out of Capital, and that the Manager and the Auditor were liable for damages to the like amount.

In the *London and General Bank case*, (1895), it was held that an auditor is guilty of misfeasance if he knows that the Balance Sheet fails to

disclose the true state of affairs and does not report the fact to the shareholders.

This was an appeal against an order of the Court declaring the Auditor and the Directors of the Bank jointly and severally liable to pay to the Official Receiver of the Company the amount of dividends paid by the Bank for the years 1890 and 1891. The Auditor had failed to bring to the notice of the Shareholders the fact that there was an over-valuation of Assets shown in the Balance Sheet of the Company which resulted in such dividends being paid out of Capital.

The Bank had advanced large sums to customers by way of loans and overdraft on current accounts on wholly insufficient securities. Interest on such loans was brought into credit, whereas the same was never paid. Heavy losses arose in respect of these loans, and this was one of the chief causes of the bank's failure. The Auditor was fully aware of this lack of proper security and that proper provision had not been made in respect of Doubtful Debts. He had made a report to the Directors fully bringing these facts to their notice, but the Directors refused to alter the accounts. In his report to the shareholders, however, the Auditor merely stated that "The value of the assets as shown by the Balance Sheet is dependent upon realisation."

As a result of the decision in this case, two important points were clearly brought out. Firstly, it was held that the auditor of a Limited Company is an "Officer" of that Company, and is, therefore, liable to misfeasance proceedings, and secondly, that an auditor is guilty of misfeasance, who on being dissatisfied with the accounts of a Company does not plainly bring to the notice of the Shareholders the grounds for his dissatisfaction in his Report.

The Judgment of Lindley, L. J., contains the following declaration of principle:—

"It is no part of an Auditor's duty to give advice either to directors or shareholders as to what they ought to do. An Auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably, or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce. Assuming the books to be so kept as to show the true position of the company, the Auditor has to frame a Balance Sheet showing that position according to the books, and to certify that the Balance Sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying

himself that they show the true financial position of the company. . . . An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer ; he does not guarantee that the books do correctly show the true position of the company's affairs ; he does not guarantee that his Balance Sheet is accurate according to the books of the company. If he did, he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part—say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this."

"Such I take to be the duty of the Auditor ; he must be honest—that is he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true."

"What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little inquiry will be reasonable and sufficient ; and in practice, I believe, business men select a few cases haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused, more care is obviously necessary, but still an Auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion ; and he is perfectly justified in acting on the opinion of an expert where special knowledge is required."

"The Balance Sheet and certificate of February 1892, that is, for the year 1891, were accompanied by a report to the directors of the bank. Taking the Balance Sheet, the certificate, and report together Mr. Theobald stated to the directors the true financial position of the bank, and if this report had been laid before the shareholders, Mr. Theobald would have completely discharged his duty to them. Unfortunately, however, this report was not laid before the shareholders, and it becomes necessary to consider the legal consequences to Mr. Theobald of this circumstance."

"A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms. Still, there may be circumstances under which information given in the shape of a printed document circulated amongst a large body of shareholders would by its consequent publicity be very injurious to their interests and in such a case, I am not prepared to say that an Auditor would fail to discharge his duty if, instead of publishing his report in such a way as to ensure publicity, he made confidential report to the shareholders, and invited their attention to it, and told them where they could see it. The Auditor is to make a report to the shareholders but the mode of doing so, and the form of the report are not prescribed. If, therefore, Mr. Theobald had laid before the shareholders the Balance Sheet and the Profit and Loss Account accompanied by a certificate in the form in which he had prepared it, he would perhaps have done enough, under the peculiar circumstances of the case, I feel, however, the great danger of acting on such a principle, and in order not to be misunderstood, I will add that an Auditor who gives shareholders means of information instead of information in respect of a company's financial position does so at his peril, and runs the very serious risk of being held, judicially, to have failed to discharge his duty."

"In this case I have no hesitation in saying that Mr. Theobald did fail to discharge his duty to the shareholders in certifying and laying before them the Balance Sheet of February 1892, without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words "The value of the assets as shown on the Balance Sheet is dependent upon realisation.".....It is a mere truism to say that the value of loans and securities depends upon their realisation. We are told that a statement to that effect is so unusual that the mere presence of

those words is enough to excite suspicion. But, as already stated, the duty of an Auditor is to convey information, not to arouse inquiry, and although an Auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this case, its language expresses no more than any ordinary person would infer without it."

In the **Kingston Cotton Mills case, (1896)**, it was held that it is not the duty of an auditor to take stock, and that in the absence of suspicious circumstances, if the auditor accepts the certificate of some responsible official of the company, he is not guilty of negligence.

In this case, the Company's accounts had been falsified to a very considerable extent by a systematic over-valuation of stocks on hand, thus resulting in dividends being paid out of Capital. The Auditors relied upon the value of the stock-in-trade as appearing in the Stock Books and the Summary of the stock as certified by the Manager. The item of Stock-in-trade was shown in the Balance Sheet with the note, "As per the Manager's Certificate." It was held on appeal that an Auditor is entitled to rely upon the representations of responsible officials provided he exercises reasonable care, and that in the absence of suspicious circumstances, he is not guilty of negligence merely by accepting their certificate as to the valuation of stock.

Lopes, L. J., in the course of his judgment, made the following observations upon the duties of Auditors:—

"It is the duty of an Auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful and cautious Auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An Auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful." His Lordship then referred to the circumstances which led to the Auditors being deceived, and came to the conclusion that they were not wanting in skill, care or caution, in accepting the figures of the manager, and he concluded as follows:—"The duties of Auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate. I should be sorry to see the liability of Auditors extended any further than in *re The London and General Bank*. Indeed, I only assented to that decision on account of the inconsistency of the statement made to the directors with the Balance Sheet certified by the Auditors and presented to the shareholders. This satisfied my mind that the Auditors deliberately concealed that from the shareholders which they had communicated to the directors. It would be difficult to say this was not a breach of duty. Auditors must not be made liable for not tracking out ingenious and carefully-laid schemes of fraud, when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an Auditor intolerable."

In the case of the Irish Woollen Co., Ltd., (1900), it was held that, if an auditor fails to detect falsifications which should have been discovered by the exercise of reasonable care and skill in the course of his duties, he is liable for any damage the company may sustain by reason of his failure.

In this case, the question before the Court was whether the auditor was or was not responsible for the non-detection of fraud. The liability of the auditor was determined on the basis of the general principles laid down in the **London and General Bank** case, and the auditor was found in a material respect to have failed in the due discharge of his duties. Dividends had been improperly paid out of capital as a result of the falsification of the company's accounts by over-valuation of Stock and Book Debts, and by an under-statement of Trade Liabilities.

The under-statement of liabilities arose through the fraudulent suppression of Invoices which were entered in the subsequent period. It was held that this would have been discovered if the auditor had called for the Creditors' Statements and checked them with the Ledger Accounts concerned, and accordingly, he was held liable in damages. In regard to stock, it was held that it was not the duty of the auditor to take stock, and in regard to book debts, it was held that, with due regard to the facts in this case, he was not responsible for insufficiency of the provision in respect of Bad Debts or the omission to provide for Cash Discounts, and, under the circumstance, there was no ground for alleging negligence against him.

Part of the judgment reads as follows:—

"Mr. Kevans seems to have done little of the actual work himself, and the evidence varies as to the nature of the supervision which he gave to it; the investigation of the books he deputed to his assistants, and it must be on the faith of their representations that he certified the Balance Sheets. I presume this course is not unusual, and that an accountant with a large business is not supposed to do everything himself. The Auditor is bound to give reasonable care and skill, but this can also be exercised by his deputy. I do not think there is anything to be gained by considering in the abstract the duties of an Auditor of a joint-stock Company. He is entitled to see the company's books and the materials for their books, and also to ask for explanations. But he is not called on to seek for knowledge outside the company, or to communicate with customers or creditors. He is not an insurer against fraud or error; and, if fraud is alleged, it must be shown with precision the acts of negligence for which he is said to be responsible."

"There was certainly no duty cast on the Auditor to take stock. What he did was to have the calculations checked in his office, and this was done with proper care. Mr. Kevans said he was particularly careful as to the deduction for discount, and as far as I could gather, the universal rate of 10 per cent seems reasonable. Moreover, an Auditor has nothing to do with the terms upon which the company or a trader buys or sells. As to No. 2 the charge in this is that the allowance made for the trade discount of $2\frac{1}{2}$ per cent was omitted. This is a purely technical question. Mr. Kevans says that the proper method of dealing with these debts was to return them as they stood in the books, and to bring the discount, when it was allowed, to the Profit and Loss Account. Mr. Pixley said it would not be scientifically correct to deduct these discounts. This seems to be in accordance with common sense, and it is to be

noted that although Mr. Garde, as liquidator, corrected the Balance Sheets by marking off these discounts, he never thought of doing so when conducting the audit. As to the provision for the 'bad debts', if there is any one thing upon which an auditor is dependent upon the officers, it is the writing off, or the making of a prospective allowance for, bad debts. He has no personal knowledge of the customers, and Mr. Kevans seems to have taken particular attention in reference to this. He said 'he had some special knowledge on the subject, that he saw all ascertained bad debts duly written off, and that there was a fund amounting to £500 as a provision therefor.' For the foregoing reasons, there is no ground for alleging negligence against Mr. Kevans on the 'assets side' of the Balance Sheet. As far as this portion is concerned, I think the Balance Sheets were properly and carefully prepared, and there was nothing dishonest or negligent on the part of anyone; but if there was, it was not on the part of Mr. Kevans or of his representative."

"Now dealing with 'sundry creditors'; here evidently there is a fraud, and a curious thing is that no one seemed to have derived any benefit from the fraud. . . . The creditors' accounts in the Ledger did not show all the goods purchased up to the time of the audit, nor could the Auditor discover the omissions on account of many of the invoices being either 'suppressed' or not put into the book until a later date—a process described as 'carrying over'. . . . It seems strange that a system of fraud so long continued, and for so extensive a period, was never detected by the Auditor. Once or twice he noticed something, and the explanation that was given was 'that the goods were not taken into stock.' The question is, was it negligent not to have seen this? There is no doubt that both the suppression and carrying over of invoices would have been detected if the Auditor had called for the creditors' statements of accounts upon which payment was ordered, and compared them with the Ledger. I should have thought this was part of the Auditor's duty for many reasons; but all the Accountants examined, except Mr. Southworth, stated that this course is never taken unless there is something to arouse suspicion. Mr. Pixley, the eminent London accountant, says it could not well be done except in the case of a very small concern. In the face of such evidence I should not leave myself at liberty to hold that Mr. Kevans' assistants were guilty of negligence in not looking at these statements of accounts if they were engaged in an ordinary audit. Little time is allowed for doing so but in this case there was this system of monthly checking. . . . I am unable to conceive how, if there was nothing wrong about this monthly checking, it did not lead at an early period to the detection of the frauds in this Ledger. Mr. Kevans ought to have found out, by the accounts, the payments that were made—and no better means could be adopted than that of a comparison with the statements of accounts. It ought to have been done in some way, and, if it had, detection would have been certain."

"I do not base my decision on this alone; apart altogether from the statements of account and the monthly check, I do not understand how the carrying over of the invoices could have escaped detection by the accountant, who should have used due care and skill and who was not a mere machine. The invoices carried over were ultimately posted to the Ledger. If they were posted under their true dates, it would be at once apparent that they were not entered in at the proper time. If they were posted under false dates, why was this not detected when the Ledger Accounts were checked with the invoices? and when no invoices came into the books, it is admitted that this ought to have excited suspicion. For these reasons I am of opinion that if due care and skill had been exercised, the carrying over and the suppression of invoices would have been discovered, and the Auditor is liable for any damage the company has sustained from the under-statement of liabilities in the Balance Sheet due to this cause."

"As regards the measure of the duty of a gentleman employed, as Mr. Kevans was in this case, the result is the same, as it occurs to me, in all cases in which professional skill is employed, except one, the peculiar instance of a barrister. The measure of duty is the bringing of reasonable care and skill to the performance of the business directed to be done, having regard, first to the contract of employment, then to the character of the business itself, to the remuneration of the defendant and to all the other circumstances of the case. In strict rule, however, the measure of the duty is to be ascertained by applying to all the circumstances of the case the best consideration, so as to ascertain what ought to have been done under the circumstances."

In the *London Oil Storage Co., Ltd.*, case, (1904), it was held that an auditor is liable for damages if he fails to verify the existence of an asset shown in the Balance Sheet.

The Auditors had failed to verify the existence of the Petty Cash in hand, which was actually only £30 at the date of the Balance Sheet, whereas the books of account showed £790, the difference having been misappropriated by the Secretary over a series of years. The auditor's clerk had compared the balance as shown by the Petty Cash Book with the balance as indicated by the Petty Cash Account, but had omitted actually to count the cash. It was proved that the Directors had by their negligence contributed largely towards this fraud, and, for this reason, the auditors were held liable in damages for breach of duty for a nominal sum of £5-5-0.

Alverstone, C. J., said the following:—

"The auditor most undoubtedly does undertake very considerable responsibilities, and is liable for the proper discharge of his duties, and if by the neglect of his duties or by want of reasonable care, he neglects his duty, and damage is caused to the company as such, he is responsible for that damage. . . . The plaintiffs must satisfy you that the damage has been occasioned, to whatever extent you think it was occasioned by the breach of duty on the part of the auditor. . . . The conduct of the directors is no answer to any breach of duty by the defendant, but it is a circumstance you must take into consideration, because if you are of opinion that the loss was occasioned by the man stealing the money in consequence of there being a want of proper control over him, then the fact of there being a breach of duty by the auditor is what we always call a *causa causans*, which contributed to, but would not be the cause of, the loss. . . . Was he guilty of breach of duty, and, if so, what loss was occasioned to this company by that breach of duty? You must not put upon him the loss by reason of theft occurring afterwards or before, but you must put upon him such damages as you consider in your opinion were really caused by his not having fulfilled his duty as auditor of the company."

Re: Joseph Hargreaves, Limited (1900): Held that an auditor who refuses to certify the accounts of a company due to their incorrectness cannot be held liable if no general meeting was called by the Directors, and no accounts were submitted to the shareholders.

In this case a misfeasance summons was taken out by the Liquidator of the Company against the Directors and the Auditor for having improperly sanctioned the payment of dividends out of capital. The contention of the plaintiff against the auditor was that he should either have brought the matter to the knowledge of the Shareholders or should have resigned.

The Auditor had refused to certify the correctness of the Balance Sheet year after year as it failed to show the true position of the company, and had persistently protested against the payment of any dividend by the directors. No resolution of the directors or the company was ever passed for the payment of such dividends. No General Meeting of the company had been convened, so that it was not possible for the auditor to place his views directly before the shareholders.

The decision in the case clearly laid it down that it was no part of an auditor's duty to communicate with the shareholders in any other way than through his report upon the Balance Sheet which is laid before the company in general meeting, and when no general meeting was called, the auditor had no power to summon one.

The case presents a very unusual circumstance, and the judgment will, therefore, be found interesting.

Cozens-Hardy, J. said:—

“The question remains as between the liquidator on the one hand and the Auditor on the other. It is sought to make the Auditor liable for three dividends paid out of capital, and it is sought to make him liable under circumstances the like of which, so far as I am aware, have never occurred before. Mr. Jones has never signed any Balance Sheet; no resolution of the company or of the directors has ever been passed for the payment of a dividend; nothing has ever been done by the directors, or by anybody on the footing of any inaccurate statement, insufficient statement, or dishonest statement, by Mr. Jones. Mr. Jones told the directors that, in his opinion, the payment of the dividend which had been made before the first audit was improper, because that was only justified by reason of an appreciation of the value of the machinery, which appreciation, assuming it to be proper, ought not in Mr. Jones' view to have been carried to the credit of Profit and Loss, but ought to have been carried to a Suspense Account, unless and until the shareholders' general meeting otherwise resolved. Mr. Jones for that reason deliberately refused to sign the Balance Sheet. No general meeting was called after that. That is the result of the evidence which is before me, and there is not a particle of evidence that any such general meeting ever was called; and Mr. Jones' duties, as defined by the articles of association are first of all to examine and ascertain the accuracy of the Profit and Loss Account and Balance Sheet and to report to the company in general meeting upon it. He could not, and would not, certify the correctness of this Balance Sheet, and I think he was perfectly right in refusing to do so. He did not report upon it to the general meeting for the best possible reason—that there was no general meeting to which he could report; and it is sought really, I think, when one gets to the bottom of the case, to render the Auditor liable because he did not require a general meeting of the shareholders to be summoned, to which he could make a statement as to the improper conduct of the directors. Well, how could he have summoned a meeting? He had no more power to summon a meeting than I have. I think in Table A, five shareholders, I think it is—but never mind what the number is—can call a general meeting. But he could not call a general meeting. He did remonstrate with the directors and suggest that they should call a general meeting, but they did not do so.”

“Now, these dividends in each of the years were paid out of the bank of the company without any resolution of the shareholders in general meeting and without even any resolution of the board of directors at a board meeting, and in each and

every year the payments which are said to be, and which for the present purposes are assumed to be, improper were actually made before the audit of the accounts was completed. It would be startling, I think, to say that an Auditor who knows that dividends have been improperly paid out of capital is to be rendered liable because he does not commence an action on behalf of himself and all the other shareholders, I suppose, against the directors who have improperly paid these dividends, or does not do that which he really had no power to do—get the general meeting together and inform them of the facts. I think the duties of an Auditor are accurately, and I might almost say, exhaustively defined by Lord Justice Lindley in the **London and General Bank case**; he must be honest; he must not certify what he does not believe to be true; he must take reasonable care and skill before he believes that which he certifies is true. I think Mr. Jones has fully come up to that definition. Certainly as far as I am concerned, I am not prepared to extend the liabilities and responsibilities of Auditors to the enormous extent to which I should be obliged to extend them if I agreed with the present application. I think, therefore, the summons must be dismissed with costs as against Mr. Jones. The order will go with costs against the three directors.”

Re: Allen Gaig & Company (London), Limited, (1934): Held that the duty of the auditors was discharged when they had affixed their signature to the Report attached to the Balance Sheet and when they had sent that Report to the Secretary of the Company.

This was a misfeasance summons issued by the liquidator against the auditors, the contention being that as their Reports were not placed before the shareholders at the general meetings which were not convened by the Directors, the auditors should have communicated direct with the shareholders.

The auditors had made Reports to the members of the company, but as no general meetings were summoned by the Directors, the Reports never reached the shareholders. It was remarked by the judge that there was no means by which the auditors themselves could convene a general meeting. If such meetings were not convened, it was for the shareholders to insist upon the requirements of the statute being complied with.

Henry Squire (Cash Chemists), Limited vs. Ball, Baker & Company, (1911), and Mead vs. Ball, Baker & Company, (1911)

In these cases, actions were brought against the auditors to recover damages resulting from negligent performance of their duties. It was alleged that the auditors should have detected the inaccurate increases in stock. There had also been falsification of documents and non-disclosure of liabilities. On the other hand, it was proved that the auditors had drawn the attention of the directors to what appeared to be continual increases in the stocks, and that as to the valuation of the stock sheets they had relied on the certificates of the managing director and secretary of the company. Both the actions were dismissed with costs. The case is interesting as it laid down that the skill of the clerk must be the same as the skill of the principal.

The following extracts from the judgment form interesting reading:—

I do not agree that their duty as Auditors would be less than their duty as advising a purchaser who was buying a business.

Figures of speech are rather dangerous ; all I venture to say is, that he has got to act as a reasonable man under the circumstances of the case. He may even be a detective in some cases if there is something to arouse the suspicion of a reasonable man.

I call attention to these passages. I understand them to lay down this rule that the Auditor is not bound to take stock ; that the highest which can be put against an Auditor or accountant in the one case or the other is that he is bound to make a reasonable and proper investigation of the accounts and of the Stock Sheets so far as he can, and if a reasonable and prudent man would have come to the conclusion that there was something wrong, that then it is his duty to call the attention of his employers to it, and in that consideration he is entitled to take into account the fact that the documents are vouched by trusted servants of his employers.

I further rule, as a guidance to myself, that, with some slight exceptions where judgment and discretion come in, the skill of the clerk must be the same as the skill of the principal. The principal must not excuse himself for his clerk's negligence by saying that he employed a clerk.

Why should it be supposed that it is to arouse the suspicions of the Auditors when the fact of the increase of stock and the existence of increased stock is called to the attention of the directors by the Auditors and no comment of any sort or kind is made ?

All I say is I have yet to learn that if the Auditors call the attention of the directors of the company to the fact, they may not also rely upon the fact that the directors of the company, with that information before them, make no further comment and give no further instructions.

I must say I certainly should have thought that the fact that the attention was being called of Mr. Mead, who was a director, and of Mr. Reece, who was also a director, to this fact, and that neither Mr. Mead nor Mr. Reece, thought it their duty, or fair to the Auditors, to give them any extra caution, is a circumstance not to be lost sight of when we are dealing with alleged negligence in three constructive years.

Putting it as fairly as I can to these witnesses, I say that on turning over those sheets you see a number of alterations, but what is there to make you think that they have been tampered with by somebody ? The plaintiff says it is the number of alterations. I am a jurymen for this purpose, and all I can say is that, looking at the Stock Sheets, I should not have come to the conclusion that they had been tampered with.

It is extremely easy when you are wise after the event to pick out particular things and say that they would have indicated to you that there was something wrong about the Stock Sheets—that is the strongest that it has been put to me—calling for further inquiries. All I can say is that it does not to my mind appear to be a reasonable view.

The Republic of Bolivia Exploration Syndicate, (1913), Ltd.: In this case the Liquidator of the company took out a misfeasance summons against the Auditors of the company and claimed certain sums in respect of their negligence or breach of trust in certifying the accounts which included several wrongful payments by the company in respect of commission and profit costs. The charge failed, however, and it was decided that the Auditor of

a company in liquidation may be held liable for failure to detect *ultra vires*, but only in extreme cases will such liability be enforced fully.

Part of the judgment reads as follows:—

"There are four claims made against the respondents, the Auditors, as follows : First, for the payment of two sums—£329 10s. and £9 paid for commission for placing shares under the above-mentioned resolution, March 16, 1908 ; secondly, for £150, the agreed profit costs received by the solicitor-director Vanderpump in an amount of £250 paid to him for costs of incorporation of the company ; thirdly, the sum of £50, the agreed profit costs received by the same gentleman out of the sums paid to him in respect of rent, clerical work, and further costs ; and lastly, £36 3s. 8d. the balance of a cheque drawn by the company in favour of the Army and Navy Stores or bearer, received by Myring, and not accounted for. None of these moneys were paid by the company or its directors in consequence of any report or audit made by the respondents ; but it is contended by the liquidator that they failed in their duty in passing those accounts with these sums contained in them without drawing attention to the fact, and they were wrongful payments under the circumstances, and that the Balance Sheets which included them did not in consequence show the true financial position of the company ; and that damage accrued to the company in consequence of such alleged breach of duty."

"Mr. Woodington, one of the respondent Auditors, has given his account of his conduct as Auditor in an affidavit, upon which he has been cross-examined before me, and the result of his evidence is as follows : First, as to moneys paid for commission. Mr. Woodington attended the shareholders' meeting in December 1908. His attention was called to this item : 'And it was alleged to have been an improper payment.' Mr. Woodington said at the meeting that it was a matter for the shareholders to sanction or not, that he had no power to surcharge, and could only show what had become of the money. Mr. Woodington admitted to me that he knew there were provisions in the Act as to underwriting commissions, and that there must be authority in the articles to pay them ; but he says that when he saw the payments in the books, he looked at the Memorandum to see if there was power to pay such commission, and he found it there, as is the fact. No further mention was made of the matter, and the same item was entered and passed in the second Balance Sheet as above-mentioned without further inquiry or investigation."

"As to the £150 profit costs received by Mr. Vanderpump, Mr. Woodington says that the payment of the bill of which this forms part was authorised by the directors as appearing in the minutes ; but he never inquired whether, excluding Mr. Vanderpump, there was a quorum present at the meeting authorising it. He says that a voucher was produced to him, and that it never suggested itself to him that it was part of his duty as Auditor to decide whether the payment was legally proper or not—that he saw the minute of December 14, 1907 referring to the agreed costs of incorporation, which agreement, he presumed, was made before Mr. Vanderpump became a director. He never asked for the agreement, and it did not occur to him that there was any difficulty in a solicitor-director making a profit. He could not say whether he saw the cheques given in payment. The receipts which he saw for the money appear to refer to directors' meetings, the dates of which are wrongly given, but he made no further inquiry or investigation with regard to it. As to the £50 further profit costs made by Mr. Vanderpump, Mr. Woodington says in his affidavit : 'The whole of the items making up the said sum, with the exception of the last three'—that is, referring to a total sum of which this is part—'were expended before my said firm had been called upon to act as Auditors for the company, while the last item £15 3s. 3d. of September 19, 1911—is after my firm had ceased to be Auditors,

they not having been re-elected at the second ordinary general meeting held on March 17th and—by adjournment—June 30th, 1910. All the said payments made during the period of auditorship, were authorised or ratified by resolutions of the board of directors, and appear clearly in the books of the company'. He says, with regard to those payments, no objection to the same on the ground of illegality was raised at any of the meetings at which he was present, and he states he is not competent, nor does he consider it part of his duty as Auditor to tax a solicitor's bill of costs. With regard to the last item of £36 odd, Mr. Woodington states that this amount is the balance of a sum of £100 paid to the respondent Myring by an open cheque made payable to the Army and Navy Stores or bearer, handed to and cashed by Myring, and that he has acknowledged the receipt of the same, and that the full amount of the cheque forms part of the sum appearing on the assets side of the Balance Sheet in the items I have read."

"In support of the liquidator's contention on the above facts, it is alleged that *qua* company finance, of which they profess to be experts, auditors must at least make themselves acquainted with the general features of such legal regulations as govern the methods and restrictions as to limited companies' accounts and finance; and that the accounts as audited by them must correspond with the reality in law of the company's financial position; and that damages must be assumed to have resulted in this case from its not having been pointed out in time the directors were liable to refund those moneys."

"Now there are some legal matters which an Auditor must obviously know, as there are others which it is equally obvious that he cannot be held responsible for not knowing, and it may not always be easy to say in which category any particular case falls. I think that Auditors of a limited company are bound to know or make themselves acquainted with their duties under articles of the company whose accounts they are appointed to audit and under the Companies Acts for the time being in force. And that, when it is shown that the audited Balance Sheet did not show the true condition of the company, and that damage has resulted, the onus is on the Auditors to show that this is not the result of any breach of duty on their part. The authorities, however, are not very clear as to what, if any, is the liability of auditors of a limited company for including or passing in accounts audited by them sums paid by the company or its directors prior to the audit, and which, by reason of the want of authority in the regulations of the company, or non-compliance with some statutory provision of the Companies Acts, ought not in the particular circumstances to have been paid; nor, if any liability would otherwise exist, what is sufficient by way of warning or identification in the audited accounts for the necessary information to be expressly conveyed by the Auditors to the company in order to free them from further responsibility."

"Applying the principles in the authorities as best I can to the facts of the case, I have arrived at the following results: First as to the sums improperly paid for commission for obtaining subscriptions for shares, I am not satisfied that the respondents failed in their duty to the company in not knowing or ascertaining that the payments were under the circumstances improper in law before they passed them in the first audited Balance Sheet, especially having regard to the fact that the Balance Sheet states in terms for what the sums in question were paid. After they learned at the shareholders' meeting of December 14, 1908, that the legality of those payments was questioned, the meeting was adjourned for the purpose, *inter alia*, of inquiries being made into the matter, and the Balance Sheet and accounts were subsequently approved by the shareholders at the adjourned meeting, and I do not think that they ought to be held guilty of breach of duty for passing the same entry as to these sums in the second audited Balance Sheet; nor do I think that, having regard to the fact

that the shareholders approved them after discussion, as above-mentioned, that the liquidator has established that any damage resulted to the company from the Auditors having acted as they did."

"As to the sum received by the solicitor-director Vanderpump for profit costs, the position of the respondents seems to be more doubtful. Mr. Woodington has admitted in the box that he made no inquiries beyond asking for and being shown the receipts for payment; but, having regard to the fact that as to the payment of the £250 the minutes stated it to be part of an agreed sum for the costs of incorporation; and as to both the sums claimed in respect of profit costs that Mr. Vanderpump was not appointed a director until three months after incorporation; and to the question as to how far the Auditors were bound to ascertain that in this company no authorisation existed for directors to contract with the company and to appreciate that the profit costs of the solicitor's bill were subsequently authorised in law, I do not think I ought to make any order for payment of these sums by the Auditors, although I am far from satisfied with the way in which this part of their audit was conducted. I may add further that I am not satisfied that the shareholders would in this case, any more than in the case for commission for placing shares, have taken any proceeding against the directors if this question had been expressly placed before them by the respondents, failing which no damage would have resulted to the company from their action. As to the sum £36 3s. 8d., the bearer cheque for £100 was, together with other large sums, handed to Myring for the purchase of stores, plant, etc., and the whole of the £100 was entered in the audited Balance Sheet under this heading, with the note appended to the second Balance Sheet which I have read, and I see no sufficient ground for charging the Auditors with any breach of duty as to this."

"I do not propose to make any order against the Auditors in this summons, but, having regard to the general manner in which the audit was conducted, and to the evidence of Mr. Woodington himself, I dismiss summons against the Auditors without costs."

Arthur E. Green & Company *vs.* The Central Advance and Discount Corporation, Ltd., (1920): In this case, it was held that, under certain circumstances, an auditor may be deemed to have been negligent in accepting lists of bad debts supplied by the Managing Director.

This was an action brought by the Auditors of the Company for the recovery of their fees. The defendants put in a counter-claim alleging that the Auditors were negligent in the preparation of accounts. The defendant company was running a money-lending business, and as a result of inadequate provision for bad and doubtful debts for a number of years, the profits were wrongly inflated and bonus had been paid to the managers on the basis of such overstated profits.

The plaintiffs contended that the statute-barred debts were not reserved for because, on several occasions in the past, the borrowers had paid statute-barred debts as they did not like to incur the displeasure of money-lenders, in order that they may be able to obtain further advances.

The case is important as it deals with the question of the auditor's responsibility in accepting the provision for bad and doubtful debts as made by the managing director. It is clear from this decision that when the

auditors having made inquiries received no satisfactory explanations from the managing director, they should have placed the matter before the Board of Directors, and if they were still dissatisfied, they should have reported the matter to the shareholders. Judgment was entered in favour of the company.

Part of the Judgment reads as follows:—

“This action was brought by the plaintiffs to recover three sums claimed to be due to them, partly for agreed auditors’ fees, and partly for certain special services rendered. The defence to a considerable portion of the claim was that the work done was of no value owing to the negligence or breach of duty of the plaintiffs, and the defendants counter-claimed against the plaintiffs for breach of their duty as auditors to the company. There were numerous issues in the case, but obviously the key to the solution of most of the issues was the question whether the plaintiffs had been guilty of a breach of their professional duty. The debts of the defendant company were usually secured by sureties, sometimes by bills of sale or the deposit of small leases. The defendant company’s business was of a conservative kind, and not particularly speculative. The plaintiffs had been the auditors to the company for a great many years, and it was agreed that they should be paid so many shillings for each schedule or sheet of debtors. It was clear to both contracting parties that one of the duties of the auditors was to extract a schedule of debtors in order that the present value of the outstanding debts for the purpose of getting out the Balance Sheet, might be ascertained. At all times material to the action, Mr. Foot was the manager of the company, and he was also a director.”

“I could see no evidence that the plaintiffs were retained to do anything other than act as auditors for the company, and I am satisfied that everybody on both sides was desirous of attending to his duty, and was scrupulously honest. It is to be regretted that during the controversies that arose in the case—although not in that Court—charges of dishonesty were made against the plaintiffs, and I am satisfied that these charges had no foundation. The directors of the company were business men, and regularly attended meetings of the Board, sometimes once and sometimes more than once a week. What they did was to examine the position of the borrowers, and none of the directors made himself acquainted with or looked into the question of there being a large amount of old debts, to find out how old these debts were or how unproductive. At the same time, the auditors were perfectly well aware that the directors were meeting, and were entitled to assume that the directors were attending to what was obviously a part of their business. With regard to the auditors, the financial year of the company ended in February, and at the end of every six months the auditors presented a tentative Balance Sheet, which came before the Board, and after the directors had considered it, there was a printed Balance Sheet, which was certified. The form of the certificate throughout was substantially the same, and it ran in this form: ‘We report to the shareholders that we have examined the above Balance Sheet with the books of the company, and we have obtained all the information and explanations that we have required. In our opinion, such Balance Sheet is properly drawn up so as to show a correct view of the company’s affairs, according to the explanations given to us, and as shown by the books of the company.’ Mr. Foot died in the summer of 1917, and as soon as he died, Mr. Green came before the directors and reported to them and produced a document in which he showed most conclusively, as was the fact, that a very large amount of perfectly unproductive debts was standing on the Balance Sheet which he presented. A great many had been on the books for a great number of years. The directors, besides attending from time to time, had what they called bad debt meetings. I am perfectly satisfied that for a number of years the accounts presented showing a large part of assets and

a comparatively small percentage to reserve for bad or doubtful debts did not present a true account of the state of the company. I have to consider whether that was due to negligence of the auditors."

"The duty of the auditors was quite clear as to statutory duties. They had to make a report, and state whether in their opinion the Balance Sheet was properly drawn up so as to afford a true account or statement of the company's affairs. It was said by the company, and he acceded to the view, that the auditors belonged to a profession, a respectable profession; that they were not only to be honest but were bound to exercise an extraordinary skill, but there was a standard. They were professional people advising a company, appointed by the shareholders to do so. They had to exhibit a standard of professional skill, and if they did not come upto that standard, that was for the Judge or jury trying the case against them to say, and that was always a difficult matter to try. The case made by the directors was that they did not do certain things because they trusted to the auditors to do them. The case for the auditors was that from time to time there was a bad debts meeting of the directors to consider a certain list which was prepared by the managing director. They said the directors must know more about the assets than they could know, and that they were entitled to rely upon the directors; that they had no reason to suspect Mr. Foot. The Auditors said that when the list of bad debts came back to them for them to settle the final Balance Sheet, Mr. Foot had struck out some of the people they had put in in respect of bad debts. Mr. Foot had been described as a man who would brook no interference, and I cannot help thinking that when the directors struck these names out of the list it was upon the instructions or advice of Mr. Foot. It had been said that Mr. Foot stood to gain by being optimistic as to the state of the company's affairs. There was an article which gave the company power, after 15 per cent had been earned, to declare a bonus to the managers, and for four years such a bonus had been voted by the directors in this way. Obviously, it was to Mr. Foot's advantage to show large balances in order that the director's discretion might be exercised by awarding such a bonus to Mr. Foot himself. I have to look into the whole circumstances of the case in order to decide whether the auditors had been guilty of a breach of duty in certifying what they had certified to be a true state of the company's affairs, which I am satisfied it was not."

"I have gone into the question very carefully, and I have noticed that at one period, as late as 1913, a document was produced, and figures as to bad debts had been filled up by the plaintiffs, and a part of these had been struck out and put back again into the list of good debts, subject to reserve, at any rate, after it had been before the directors' meeting. I do not want to go into all the details, but the conclusion I have come to is that the plaintiffs were guilty of a breach of duty in the last two years complained of. There were some special circumstances connected with that. On his own initiative, Mr. Green, with his partner, had produced a large list and sent it to Mr. Foot, showing thousands of pounds of unproductive debts, and I have no doubt that they were uneasy about it, and they put it before Mr. Foot, because they were satisfied it ought to be dealt with. Mr. Foot took that away to his private house, and the directors never saw it. All they were told by the auditors was that they had made enquiries of Foot, and that he said he was too busy to attend to it, but the result was that after having no information afforded them about what were unproductive debts, the auditors went on in the old style, issuing a Balance Sheet which did not even show the shareholders the amount set aside to reserve. Everything which appeared on the books was put down as an asset. They were divided into different items. There were the balances due from borrowers and the different items of which they had been made up, and also charges and County Court costs, which merely represented County Court costs which had been incurred in respect of various

debtors. Many of these charges were in respect of debts which had failed to produce anything and they were all put down as assets. The conclusion I have come to is that the auditors, having made inquiries, did not get any satisfactory explanation. It was said that they were entitled to believe that in a money-lending business it did not matter how old the debts were, because in the long run people would come back and pay in order to be able to obtain further advances. I do not think that was a satisfactory explanation at all. There were thousands of pounds of statute-barred debts, and the idea that people would come up and pay them because they would want to be able to borrow from that company, and not from another, was not one I can accept. I have, therefore, come to the conclusion that the defendants' counter-claim must succeed."

In Re: The City Equitable Fire Insurance Co., Ltd., (1924)

This case must prove of considerable interest to auditors. Extensive frauds were perpetrated by the Chairman of the company, and an action was taken by the Official Receiver as Liquidator of the company against the directors and auditors for damages arising out of misfeasance. The auditors were charged with negligence in respect of the audited Balance Sheets for the years ending with 28th February 1919, 1920 and 1921. The charges of negligence comprised the following:—

(1) That the debts due to the company from Ellis & Co., the stock-brokers of the company, of which firm Mr. Bevan, the Chairman of the company, was a senior partner, as also from Mr. Mansell the General Manager, were shown under wrong head, viz., "Loans at Call or Short Notice" and some under the heading of "Cash at Bank and in hand."

(2) That the auditors failed to detect that there were much larger sums in the hands of Ellis & Co., than were so included in the Balance Sheet of each of the years; and

(3) That they failed to detect and report to the shareholders that the securities which were in custody of the company's stock-brokers Ellis & Co., were being pledged by that firm to its customers..

In course of the judgment it was stated that generally speaking the auditors had displayed great care, skill and industry in the discharge of their duties, and they were held not liable.

As regards the first charge, it was held that the balances owing by Ellis & Co., were shown under wrong heads, but that was a mere misdescription and this did not involve any damage to the company. Besides, if the directors choose to advance moneys to their stock-brokers or their General Manager, it was not the duty of the auditors to draw the attention of the shareholders to these debts. The auditors had also no grounds to assume that at the time of the audit the debts were not good, as the financial position of the firm of Ellis & Co., was then considered to be quite sound.

In regard to the second charge, this also failed, for although in light of the subsequent disclosures it was apparent that the transactions were of a "window dressing" character, the auditors could not be held guilty of negli-

gence in not detecting these frauds, in view of their actual knowledge of the state of affairs at the time of each audit.

In regard to the third charge, the auditors relied upon the certificate of Ellis & Co., that the securities were in their possession, and the question as to whether the auditors were justified in relying upon such a certificate from the company's stock-brokers rather than actually verifying the securities gave rise to the following important passages in the judgment.

Mr. Justice Romer said:—

“That it is the duty of a company's auditor in general to satisfy himself that the securities of the company in fact exist and are in safe custody cannot, I think, be gainsaid. If authority for the proposition be required, it may be found in the passage from Lord Justice Lindley's judgment in the *London and General Bank case*, which has already been referred to. The auditor in that case, amongst other things, ‘saw that the bills and securities entered in books were held by the bank’ and this the Lord Justice plainly treated as being part of an auditor's legal standard of duty,’ though he did not of course mean that in all cases the bills and securities should be lodged with the bank. He meant ‘with the bank or in other proper custody.’ Nor is it at all clear whether the Lord Justice meant that in all cases the securities should be personally inspected by the auditor. For an auditor may ‘see’ that the bank holds the securities in the sense that he satisfies himself to the fact. In the case of a responsible and reputable bank this, according to the evidence of Mr. Van de Linde, would seem to be the custom of auditors. But I think that it is a pity that there should be any such custom. It would be an invidious task for an auditor to decide as to any particular bank whether its certificate should be accepted in lieu of personal inspection. The custom, too, at once raises the question, much debated in the course of the evidence before me, whether the courtesy of accepting a certificate should be extended to an insurance company or a safe deposit company. Indeed, if once it be admitted that, in lieu of inspecting the securities personally, the auditor may rely upon the certificate of the person in whose custody the securities have properly been placed, the auditor would be justified in accepting the certificate of any official of the company who happened to be in charge of the safe in which the securities are placed, supposing such official to be a reputable and responsible person. At some-time or other it will, I think, have to be considered seriously whether it is not the duty of an auditor to make a personal inspection, in all cases where it is practicable for him to do so, whatever may be the standing and character of the person or company in whose possession the securities happen to be. I do not, however, propose to investigate this question further upon the present occasion. For an auditor is not in my judgment ever justified in omitting to make personal inspection of securities that are in the custody of a person or a company with whom it is not proper that they should be left. Whenever such personal inspection is practicable, and whenever an auditor discovers that securities of the company are not in proper custody, it is his duty to require that the matter be put right at once, or, if his requirement be not complied with, to report the fact to the shareholders, and this whether he can or cannot make a personal inspection. The securities, retained in the hands of Ellis & Co., for periods long beyond the few hours in which securities must necessarily be from time to time in the possession of the company's stock-brokers, were not in proper custody. That Ellis & Co., were at all material times regarded, and reasonably regarded, by Mr. Lepine as a firm of the highest integrity and financial standing is not to the point. A company's brokers are not the proper people to have the custody of its securities, however respectable and responsible those brokers may be. There are of course

occasions, when, for short periods, securities must of necessity be left with the brokers, but the moment the necessity ceases, the securities should be lodged in the company's strong room or with its bank, or placed in other proper and usual safe-keeping. In my judgment, not only did Mr. Lepine commit a breach of his duty in accepting, as he did from time to time, the certificate of Ellis & Co., that they held large blocks of the company's securities, but he also committed a breach of his duty in not either insisting upon those securities being put in proper custody or in reporting the matter to the shareholders. This was negligence, and but for Article 150, it would be my duty so to declare and to order Messrs. Langton & Lepine to make compensation for all the damages that such negligence caused to the company, directing an enquiry to ascertain what those damages were. For it is settled by authorities that are binding upon me that an auditor is an officer of the company within the meaning of section 215 of the Companies (Consolidation) Act, 1908, though Mr. Stuart Bevan, while admitting that it was not open to him to argue the contrary in this court, reserved to his clients the right to contest the point in a superior one. But Article 150 in express terms includes the auditors of the company in the protection that it gives, and it must be taken to be one of the terms upon which the auditors were employed and gave their services. They are therefore protected, unless the negligence of Mr. Lepine in the matter was wilful. This it certainly was not unless I am mistaken as to the true meaning of the phrase 'wilful negligence.' I have heard Mr. Lepine's evidence in the witness box, and I have inspected many of the numerous documents prepared by him for the purposes of the audits that he conducted. I am convinced that throughout the audits that he conducted, he honestly and carefully discharged what he conceived to be the whole of his duty to the company. If in certain matters he fell short of his real duty, it was because, in all good faith, he held a mistaken belief as to what that duty was. As against him and his partner, the application of the Official Receiver must accordingly be dismissed."

The Master of the Rolls said:—

"Now I come to the last point, part of which is contained in the third charge, and that is the failure to detect the fact that much larger sums were in the hands of Ellis & Co., at the date of the balance sheet, and the failure to detect and report that the securities were in the hands of Ellis & Co. Now upon that matter I want to say a word or two about the evidence. In fact Mr. Lepine inquired from the bank and got a certificate from the bank that a certain number of securities were there, and then he turned to Ellis & Co., and he got from Ellis & Co., under the signature of Ellis & Co., a certificate attached to the document, apparently not by Mr. Bevan but by one of the partners, a certificate that a number of securities were in the hands of the stock-brokers. It is said it was quite wrong to accept the certificate of the brokers, and we are asked to accept the evidence of Mr. Cash and Mr. Van de Linde as meaning this, that you may accept the certificate of a bank apparently in all cases, but you may never accept the certificate of stock-brokers. I cannot agree that the evidence is so to be read, or is intended by the witnesses to be so understood. What I think the witnesses meant to express was this: Banks in ordinary course do hold certificates of securities for their customers; it is a part of their business, and therefore certificates in the hands of bankers are in their proper custody, and if then a bank is a reputable bank, a bank which holds a high position, you may legitimately accept the certificate of that bank because it is a business institution in whose custody you would expect both to find and to put securities and also it is respectable, but the fact that it calls itself a bank does not seem to me to conclude the matter either one way or the other. On the other hand, it may be said that it is the duty of an auditor not to take a certificate as to possession of securities unless from a person who is not only respectable—I should prefer to use the word 'trustworthy' and also of that class of

persons who in the ordinary course of their business do keep securities for their customers, and it may be said that a broker does not in the ordinary course of business keep securities for his customers, and therefore he is ruled out because the auditor ought not to accept from a person of that class, whether he be respectable or not, a certificate that he has got securities in his hands. Now, accepting the rule as stated, that it is right to find the securities in the hands of the bank whose business it is to hold securities, and applying the proviso that that bank must be one that is trustworthy, it seems to me that that rule may be a right rule to follow, and I think it is *prima facie*, but it is going too far to say that under no circumstances may you be satisfied with securities in the hands of a stock-broker, because it seems to me in the ordinary course of business you must from time to time, and you legitimately may, place in the hands of stock-brokers securities for the purpose of their dealing with them in the course of their business. With a large institution like the City Equitable Company with a very considerable amount of investments to buy and investments to sell, it may well be that for the purpose of the convenience of all parties it may have been a useful method of business even if it had been examined with the most exiguous care, for the directors to decide that they would in the interests of their business leave securities of a considerable amount in the hands of their stock-brokers, who, I suppose at that time held a position not less trustworthy or respected than the City Equitable itself. I therefore do not wish in any way by anything that I say to discharge the auditors from their duties, as laid down in the *Kingston Cotton Mills case*, far less do I wish to discharge them from their duty of seeing that securities are held and only accept the certificate that they are so held from a respectable, trustworthy and responsible person, be that person the bank or be it somebody else, but in applying my mind to the facts of this case I am not content to say that simply because a certificate was accepted otherwise than from a bank therefore there was necessarily so grave a dereliction of duty as to make Messrs. Langton & Lepine responsible. In thinking in the light of the evidence which has been given it is for the auditor to use his discretion and his judgment, and his discrimination as to who he shall trust; indeed I think that is the right way to put a greater responsibility on the auditors.

If you merely discharge him by saying he accepted the certificate of a bank because it was a bank, you might lighten his responsibility. I think he must take a certificate from a person who is in the habit of dealing with, and holding, securities, and who he, on reasonable grounds, rightly believes to be, in the exercise of the best judgment, a trustworthy person to give such a certificate. Therefore I by no means derogate from the responsibility of the auditor, I rather throw a greater burden upon him, but at the same time, I throw a burden upon him in respect of which the test of common sense can be applied and common business habits can be applied, rather than a rigid rule which is not based on any principle either of business or common sense."

Royal Mail Steam Packet Company Case, (1931) Rex vs. Lord Kylsant

In this case, the most vital questions relating to the formation and accumulation of undisclosed reserves and their utilization at a later date were fully considered, and in view of their utmost importance to the profession, a close study of the views expressed by the learned judge seems to be highly necessary for the students and practitioners alike.

Lord Kylsant who was the chairman of the company was criminally prosecuted on charges of presenting to the shareholders the company's accounts for the years 1926 and 1927 which he knew to be false, and concealing from them the true position of the company in the annual reports with intent to deceive. The auditor was charged with aiding and abetting the chairman in this offence. Both the accused were ultimately acquitted of these charges.

The R.M.S.P. was formed under a Royal Charter and not registered under the Companies Acts. The regulations under the Charter, however, in regard to the accounts and audit were practically identical with those under the Companies Acts.

The company had made substantial profits during the war period and up to the beginning of 1921. Subsequent to that, the profits went down considerably, and the company was only enabled to produce an annual surplus and pay its debenture interest and dividends on preference and ordinary shares during the years 1921 to 1927 by transferring to Profit and Loss Account special credits amounting approximately to £5,000,000 in respect of recoveries of excess Profits Duty, excess Taxation Reserves and Bonuses received from subsidiaries declared and paid out of past profits.

It was not argued that the above credits were improper in any way, but the contention of the crown was that the "special credits" were shown in one lump sum of £439,212 on the credit side of the published Profit and Loss Account for the year 1925, under the heading of "Balance for the year, including dividends on shares in allied and other companies, adjustment of taxation reserves, less depreciation on fleet, etc.," without any reference to the fact that this large credit of £439,212 had no bearing whatsoever on the earnings of the year in question. Besides, a transfer of £150,000 from Reserve was separately stated and that this constituted a deliberate false representation to the shareholders that the company was making a trading profit, when in fact it was making a trading loss.

It may be pointed out that upto the year 1923, the credit on the Profit and Loss Account appeared in one sum under the caption of "Profit for the year." In 1924 it was altered to "Balance for the year," and in 1925 the additional words "Adjustment of Taxation Reserves" were also inserted at the instance of the auditors.

The following extracts from the judgment are of particular interest as they raise many points of importance to auditors:—

"We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice. We have heard a great deal about what is often done in practice, and it may be reasonably and properly done, but the question may arise some day, and possibly will arise, in some appropriate proceeding in order to find out and elucidate these very special matters. It was said by a very learned judge on one occasion, by way of observation and not by judgment that a company, that is to say the shareholders, could

not complain if the position of the finances of the company was better than the accounts disclosed. That has been quoted from time to time as a justification for this method of keeping reserves secret. But there may be very great evils if those who have the control and management of the companies, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, have very large portions of the company's assets left in the secret disposition of the managing authority. It may work very well in many cases; no doubt it does. It is a practice which is being followed, no doubt, by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities, and almost breaches of faith. It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they form any view about it at all? How can they consider whether it is something which they are satisfied with or which they are not satisfied with?

Taking this case, without entering into the thorny question, as to whether you have here anything which can be called reserves or not, you have here a large sum of money, or perhaps a series of large sums of money, the nature of which and the propriety of which has remained a secret from the shareholders, and the use of which has remained a secret from the shareholders, if you exclude certain things which appeared in the three last balance sheets with which we are concerned. What has happened as a result of that? We know that there were balance sheets and profit and loss accounts published for a period of seven years which did not disclose one way or the other whether the company was earning any profit or not, and during those seven years there was expended out of those items, which were mainly connected with the war, a sum of no less than five million pounds—not out of current earnings at all, but out of these items which in the main, arose out of the war; and during all that period the shareholders were told nothing, and they drew their dividends presumably in the simple faith that all was well with the condition of the company. It is said: "Very well, they got their dividends. Times might have changed and although these items of income came to an end others might have taken their place and conditions might have improved." But, on the other hand, surely if the shareholders had been told (I do not say who is responsible for the moment) that this company had no earnings—because earnings are the life blood of a company, and a company cannot go on indefinitely, using its capital assets unless it is earning—if they had been told that this company had no earnings, surely they might have taken steps, as could be done, and as has been done in other cases, for the reconstruction and rearrangement of the company's affairs, the cutting down of expenditure, the reduction of services, and all those things which have to be done when a company is not paying its way. The sooner that is done the better, and the better hope there is of the company surviving the troublous times.

I will say something about what appeared on the profit and loss account a little later. It was never brought to the shareholders' knowledge what the position was. It may seem incredible that this could go on in a big company for all those years, but so it was, and then eventually, at a period which is outside the period we are concerned with, something had to be done and some steps had to be taken. It is a little astounding, and one cannot help wondering whether those who manage big companies do not forget sometimes that the body of directors of a company are the agents and the trustees of the shareholders, that they owe them full information, subject to proper and reasonable commercial necessity, and it is their interests that they have to study. They are not to regard shareholders as sheep, who may look up if they are not fed; they are the people whose money they are using, and it is to be remembered that

a joint-stock company is a creation of law. A joint-stock company has the enormous advantage of limited liability, and the legislature has intended, it seems to me, although by halting steps, to secure that those who enjoy those privileges of limited liability and who control and manage joint-stock companies should be subject to some condition as to publishing their accounts, at least to the shareholders and at least to those who are entitled to be summoned to general meetings.

The law has recently been altered in the Act of 1929, and for the first time that has provided for the sending to shareholders of a balance sheet, and a profit and loss account in every year ; and there are penalties imposed upon directors who do not do that. The balance sheet must contain a summary, among other things, of the liabilities and assets together with such particulars as are necessary to disclose the general nature of the liabilities and assets of the company, and to distinguish between the amounts respectively of the fixed assets and the floating assets, and state how the values of the fixed assets have been arrived at. It further provides that there is to be a report by the directors with respect to the state of the company's affairs, and the amount, if any, which they propose to carry ~~in~~ the reserve fund, or any other reserve. It may be said that that does not in terms prohibit the creation of any reserve which is not shown specifically on the balance sheet, and it may be said that in a matter of domestic concern like the keeping of reserves by appropriate regulations the shareholders may agree to a reserve being accumulated, the exact amount of which is not specified in the balance sheet or the profit and loss account. That is a question which, no doubt, will require very careful consideration in some future case, but it does appear to me, as at present advised, that the terms of the sections which I have read cannot possibly justify the omission of any amount of any reserve from the balance sheet and the profit and loss account altogether. There may be some justification for the maintenance of an undisclosed or secret reserve, if the fact that there was such a reserve was clearly specified somewhere in the report, so that the shareholders could know, and if the majority of them desired to insist on its disclosure and its utilisation they could do so. However that may be, it is clearly the intention of these sections that the accounts of companies in future should be published with greater particularity and with greater information to the shareholders.

Then there is the question of the auditor, because, as you will remember, the law requires the appointment of an auditor, who is the servant of the company, and his duty is to report to the shareholders, on proper examination, on the accounts which the directors are going to present to the company. The law does not impose an impossible burden on auditors ; it does not make them insurers ; it does not require of them skill and vigilance which is beyond their power ; but it does require them to report, and to report on the accounts would certainly include a very careful investigation of the profit and loss account as one of the accounts, even if it is not expressly covered in the certificate which is generally accepted as a complete report. Then they have to give a certificate as to whether in their opinion the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them. Now, if the account on which the current expenses of the company are being met, is being fed by undisclosed reserves, it seems to me very difficult to see how the auditor can discharge his duty of giving a true and correct view of the state of the company's affairs without mentioning and drawing attention to this fact, which may be of the most vital importance, as indicating the state of the company's affairs. No doubt an auditor, in his very delicate and difficult duties, must use a certain amount of discretion, but, whatever discretion he may feel that he is justified in exercising within the limits of what is reasonable, he must remember that he is under a statutory duty, and that he may come under the penalties of the law

if he fails in that duty, at least in specific ways which I need not trouble about at this moment.

An auditor is not concerned with questions of policy, and it is not for him to say whether a dividend is properly or improperly declared, but if he sees on the accounts there is something in the accounts to which he ought to draw the attention of the shareholders, it is his duty to do so, and either he should not sign the certificate at all or he should sign it with some qualification such as the circumstances require.

I do not gather now that there is any real question as to the general accuracy of the view that a very heavy or a very long, protracted utilisation of secret reserves, in order to keep the company going, is a serious matter which, quite apart from anything I have said about the general law, ought to be disclosed, on any view of the position, to the company.

Then you will consider this question, whether the essence of the matter is simply this, that the shareholders ought to have been told that the company was being kept going by means other than current earnings.

On the other hand, it is pointed out that the amount drawn from taxation reserves which figures under the word "Adjustment" is a very heavy amount indeed—£550,000—and it is said, in view of all the circumstances, to make that anything but a misleading document, in view of the large amount drawn from reserves in proportion to all these other figures, that ought to have been clearly and specifically indicated, so that the true position of the company could have been disclosed to the shareholders; and that in view of the fact that it ought to have been disclosed, and that the accountant signed his certificate, which may be is only limited to the balance sheet, but which is generally understood to refer to the profit and loss account, which would be incorporated in the balance sheet—in view of the fact that he signed the certificate, it is said, and it is for you to consider, that that is not anything, other than a written statement, false in material respect, because it conceals the true position of the company in that year from the shareholders, who are entitled to be told, and to whom this report is addressed.

In the case of Mr. Morland, it is obvious enough that in the year 1926, when the accounts of 1925 were being dealt with, he was not satisfied with the position, because he thought that some words ought to be added to intimate to the shareholders that the moneys which we know were being used in order to produce the balance which appears. That being so, he thought, as indeed he has admitted, that without some qualification or another he ought not to give the certificate and the qualification which he suggested, and which he put in, was, those words, which you must all be tired of hearing, "Adjustment of taxation reserves"—those words which Lord Plender has turned to plain English in the way in which I have already said. Mr. Morland says that that satisfied his doubts; he thought then that he had done enough to cure the defective character of the balance sheet or profit and loss account with those words. If he was right in that, if he had discharged his duty sufficiently and properly, then it seems, on any view, that the matter is, or ought to be, at an end. If, on the other hand, he was wrong in this sense that in a civil action or in an action against him for not showing due care and skill, he would be held liable as a defendant because he had broken his duty and not fully discharged his office, then, again, his liability would be a civil liability in damages."

From a consideration of the judicial views expressed in this case, it appears that a distinction must now be drawn between the creation and existence of a secret reserve and the use thereof in subsequent years, and that whereas

the maintenance of secret or internal reserves may be quite proper and legitimate in many cases, some indication of the fact must be given to the shareholders when at any subsequent stage such a reserve is drawn upon, more especially when the amount thus utilised is relatively a substantial sum in comparison with the current net earnings, in order that a wrong and misleading impression as to the true earning capacity of the business may not be conveyed to the shareholders. The difficulty that arises, however, is that in many cases, the very object of a Secret Reserve would be frustrated if any disclosure is made of the utilisation thereof; and in cases where the nature of the business would call for the creation and maintenance of a hidden reserve with the object of enabling the company to meet any unforeseen claims or liabilities without having recourse to the reserve funds which are disclosed in the accounts, in order to avoid the disclosure of a loss to a rival company, or to maintain the confidence of the customers, the creditors and the public by giving an impression of stability to a sound but fluctuating undertaking, a question must necessarily arise whether the auditor would be said to have done his duty in serving the best interests of the shareholders, if he made a disclosure of the company having had to utilise its Secret Reserve. Ordinarily, it would seem, therefore, that an auditor cannot object to an Internal Reserve when the nature of the company's business would require its maintenance by way of a precautionary measure with the object of ensuring its financial stability. On the other hand, a vital question that must arise under such a circumstance, is, "Would the auditor be said to have fully discharged his statutory duties by grossly understating the true position, and presenting to the shareholders an annual balance sheet giving an entirely wrong and misleading view of the company's affairs, and would this not in itself constitute an offence under statute?"

The whole position of the auditor is no doubt very delicate and untenable, under such a circumstance, but opinions have been expressed by the ablest exponents of accounting that the extent to which an auditor can pass secret reserves or the use thereof without comment is mainly a question of degree, and it is for the auditor to come to a decision on the matter after most carefully considering the whole of the facts and information before him and with due regard to the faithful discharge of his duties. The general attitude of the Court, in this connection now seems to be that, save in exceptional circumstances, if the auditor finds that the secret reserves have been created by a company beyond its legitimate requirements, or that they have been consistently utilised for substantially augmenting the year's profits so as to give a false impression of the current earnings, it would become his duty to give a clear indication of such facts either on face of the accounts or in his report to the shareholders, and that he would be running grave risks if he failed to do this.

Armitage vs. Brewer and Knott, (1932)

In this case, damages were claimed from the auditor in respect of defalcations committed by an employee and left undiscovered, and the question of whether or not the auditor had exercised reasonable care and skill came before the Court. The frauds were perpetrated by the book-keeper Miss Harwood who was prosecuted criminally. There was no system of internal check, and she was in complete charge of the books and payment of wages. The case is important as it dealt with the extent of the auditor's duties in regard to vouching and verification of book entries. The auditor was found guilty of negligence and judgment was entered against him for £1,259. The point to be borne in mind, in this case, is that the auditors had undertaken to do a continuous and detailed audit.

In course of his judgment, Mr. Justice Talbot made the following observations:—

"The documents at the beginning set out that the defendants would vouch all payments with receipts in petty cash, check calculations and additions of all wage sheets, check totals of wage sheets into wages book and check weekly totals, with other detailed provisions, and accountants undertaking duties of that kind could not be heard to excuse themselves on the ground that this or that was a small matter; they undertook a rigorous check, and they did so because that was what their client wanted. He told them he wanted protection against petty frauds. The defendants knew uncontrolled powers were committed to the person in the office Miss Harwood filled. They did not refuse the audit because of a risk of employing one woman in that kind of position. What was required of them in the circumstances entailed more laborious work and more vigilance. They undertook that work, and the reassurances that Mr. Armitage frequently asked for they gave. That was a sufficient account of the duty they undertook. Had it been performed with the care they owed the plaintiff and which could be expected under their retainer from competent and upright professional people? His Lordship thought the answer to that was that it had not. However much it might be wrapped up, the defendants' case came to this, that systematic fraud for two and a half years by one person, could not be detected by the exercise of reasonable care on the part of the accountants. His Lordship did not like to use strong language, but that appeared to him to be bordering closely on nonsense.

It was doubtless true that to detect required minute examination of a large number of documents, but that was exactly what the defendants undertook to do.

As to the suggestion that some things were too trivial to notice, audits differed greatly as to scope and special instructions. A 6s. 1d. had been altered to 16s. 1d. That was passed in what purported to be a meticulous examination. The most casual inspection would detect the discrepancy on the voucher; both figures were there. His Lordship was struck by the audacity with which many of these frauds were committed. It looked as though Miss Harwood had found that she had nothing very formidable to fear in the way of audit. It was the duty of the auditor to bring that 10s.—which was indicative not only of fraud but of forgery—at once to the notice of the principal. That one piece of paper raised a grave suspicion. It was of critical importance. It was by little things like that, that forgeries and frauds were found out.

But the point was that to the vouchers they did examine, the defendants did not bring proper care. It was no use looking at such documents as were found here unless one did it with scrupulous accuracy. If in turning over documents, all of one

was not seen, then the document must be taken out of the pile. The suggestion that something was the kind of thing a junior clerk would have passed was an unjust imputation on junior clerks. But if junior clerks could not do the work, they must be got rid of; auditors could not get rid of their responsibility by delegating it to junior clerks. There were many items which Mr. Clark said frankly he might have passed, but when there was something to make one uneasy His Lordship thought the defendants should have been doubly vigilant. Against systematic dishonesty the plaintiff had no protection except the defendants, and it was for the protection against Miss Harwood principally that he paid, and that he was entitled to get."

The Scarborough Harbour Commissioners *vs.* Thomas Whitehead and others, (1934)

The point that it is no part of an auditor's duty to advise the directors as to how they should carry on the business was again brought out in this case, as recently as 1934. The auditors were charged with negligence in the discharge of their duty, and damages were claimed against them to make good the loss sustained on the ground that they failed to report to the Board of Commissioners or to the Finance Committee the fact of the arrears of rent and gas-money due to them from their tenants J. Sellers & Co., Ltd.

The facts of the case are that Mr. T. Whitehead, the chairman of the 'plaintiffs' board and of the finance committee, also controlled J. Sellers & Co., Ltd. The case against the firm of auditors was that Mr. Robinson had been guilty of negligence and breach of duty to the Commissioners inasmuch as he had placed before the latter Balance Sheets which included sums owing by J. Sellers & Co., Ltd., as good debts despite the fact that they were bad or at least doubtful to his knowledge. On the other hand, evidence was produced to show that the auditors were assured by some of the trusted servants of the Board that in the matter of arrears owing by these tenants, the Board's policy was not to press for immediate payment of these debts.

Mr. Justice Crossman in his judgment held that Mr. Robinson was guilty of negligence as he failed to report the matter of the arrears of rent and gas-money formally to the Board or the Finance Committee, or alternatively, to make a note of this fact on the Balance Sheets. This decision was, however, reversed on Appeal and the Court of Appeal held that there was no dereliction of duty on the part of the auditor.

The fact that the chairman of the board was indebted to the Commissioners in respect of rent was mentioned by the auditor to certain officials whose duty it was to communicate the same to the board. Besides, the auditor knew and believed that the total sum of outstanding debts was placed before the finance committee every month, together with detailed statements from which such total has been compiled. Further, Mr. Robinson was given to understand that the policy of the Board was not to press for these debts, and he honestly believed that Mr. Whitehead's financial condition was not hopelessly bad, and had no grounds to assume that the debt was irrecoverable. The auditor was therefore not guilty of negligence and breach of duty

to the Commissioners in accepting the explanation given to him by the tried servants of the Board.

An important feature of the case was that the auditors were not appointed by statute, and, therefore, their rights and duties arose out of the contract between themselves and their clients.

In the course of the judgment the Master of the Rolls said:—

“It is difficult to reconstruct the position as it stood before Mr. Robinson. What was his duty? Was it to tell the Commissioners what debts they ought to sue for, what debts they ought to forego? Is it for him to say when indulgence ought to be given and when stringency ought to be applied? I do not think that is a right test to apply to an auditor. We must take the circumstances broadly without any particular definition, and having regard to the circumstances that prevailed in this case, I cannot say that the plaintiffs have established their charge of negligence against Mr. Robinson.”

Lord Justice Romer said:—

“I turn to the case against the auditors, and, although we are differing from the learned Judge, I confess that it appears to me that the matter can be stated very shortly. It is impossible, I think, to lay down any general rule as to what is the duty of an auditor in all circumstances and in all conditions. One must know by whom the auditor has been appointed, the circumstances in which he has been appointed, and the facts with which he has to deal, and it is then possible, no doubt, to say, as regards any particular circumstance, what the duty of the auditor was. I mention that because this case has been presented to us as though Mr. Robinson stood in the position of an auditor appointed by the shareholders of a limited company. But I do not take that view at all. I do not think he was appointed in pursuance of any statutory duty imposed upon the Commissioners to appoint an auditor. He appears to me to be appointed by them purely for their own purposes. He really stood to them in the relation in which an auditor would stand to a firm of partners who appointed him auditor to audit their accounts. But assuming he did stand in relation to the Commissioners in the same relation that an auditor appointed by the shareholders of a company stands in relation to them, as between them and the directors of the company, I still fail to see that he was guilty of any dereliction of duty. It appears to me that an auditor, even an auditor in that position, has nothing to do with the policy of the board, that is to say, if the board choose to lend money to one person or another; it is not for the auditor to criticize their action by calling the attention of the shareholders pointedly to the fact that that particular loan has been made. . . . In the present case, when Mr. Robinson discovered that the chairman of the board was indebted to the Commissioners in respect of rent, I will assume that it was his duty to let the Commissioners become aware of that fact. But he would discharge that duty if he drew the fact to the attention of someone whose duty it was to communicate the fact to the board. In the present case we know that when his own clerk informed him of this indebtedness of Mr. Whitehead, and that the Collector, Mr. Taylor, inquired about it, Mr. Robinson said that he told his clerk to go and see Mr. Gardiner, who was the clerk to the Commissioners. I understand Mr. Gardiner to say that he was not, in fact, approached by Mr. Robinson's clerk. Mr. Robinson had every reason to suppose that Mr. Gardiner had been approached, because his own clerk told him what Mr. Gardiner's reply had been. Further than that, in the year 1930, Mr. Robinson had a conversation with Mr. Johnson, I think his name was, who was a member of the finance committee, and discussed the matter with him and brought it to his attention, and further than that, Mr. Robinson knew that every month there was brought before the finance committee a statement of debts outstanding. Those debts

appear to be in certain memoranda, but in those memoranda the debts were all lumped together, and it was only the total that appeared. But Mr. Robinson understood and believed that the detailed statements from which those totals had been compiled, and which had been prepared by Mr. Gardiner, the clerk, were before the finance committee. In those circumstances I cannot see that Mr. Robinson has been guilty of any dereliction of duty. All that can be said is that he did not specifically report, did not specially call attention to, the fact that this debt had been incurred. In the circumstances I do not think it is necessary or that it was unnecessary for him to call attention specially to the fact, having regard to the inquiries he had made and the answers that he had received. I agree further that an auditor would be guilty of a dereliction of duty, if, in preparing Balance Sheets for his employers, he includes as a good asset something that he knows is not, and if it could be shown that in this case Mr. Robinson brought into the Balance Sheet as a good debt this debt of Mr. Whitehead's company, which was not in fact a good debt, I agree that the plaintiffs would have just cause of complaint against him.

But what are the facts? They are deposed to by Mr. Robinson in his evidence, and it appears that he did seriously consider the question as to whether this debt of Mr. Whitehead's company was a good one or not, and came to the conclusion, *bona fide*, no one doubts, that the debt was a good one. In those circumstances he was not guilty of any dereliction of duty in allowing these debts to appear in the Balance Sheets as good debts. If an auditor, when he has a list of debts before him, has in the case of a derelict company, to send for its Balance Sheets for the last year or so, and, in the case of an individual debtor to make inquiries through trade societies to try and get hold of a copy of the man's income-tax return, the life of an auditor would not be worth living. He has done his duty if, having no reason to suppose otherwise, he brings in the debts which the directors have allowed to be incurred, at their face value. It is only when information comes before him which suggests that the debt is not a good one, that he must either set some reserve against the debt as being a bad one, or specifically call the attention of his employers to the fact that, although it is doubtful whether it is a good one or not, he has nevertheless included it in the Balance Sheet as a good one.

In my opinion the plaintiffs have failed to show that Mr. Robinson has been guilty of any breach of duty and, in my opinion, this action should be dismissed with costs.

CONCLUSIONS

The duties and responsibilities of the auditor, as interpreted by the Courts, may be summarised thus:—

(1) An auditor should not confine himself to checking of the arithmetical accuracy of the Balance Sheet and the Profit and Loss Account, but he must see that they reflect the true earnings and present an accurate view of the company's financial affairs.

(2) He must take reasonable care to ascertain that the books of the company themselves record the company's true position.

(3) He is supposed to study the Memorandum and Articles of the Company and to see that the accounts are prepared in accordance therewith. It would be no excuse for him to say that he had not seen these Documents.

(4) Verification of arithmetical accuracy is not enough, and the auditor must see that any special provisions in the Articles affecting the accounts have been duly complied with.

(5) He must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.

(6) What is reasonable skill, care and caution must depend on the particular circumstances of each case. Where there is nothing to excite suspicion, very little inquiry will be reasonable and sufficient; where his suspicions are aroused, he must probe the matter to the bottom.

(7) He is not supposed to have an expert technical knowledge of every business of which he is an auditor, and is, therefore, entitled to rely on the statements and opinions of officials on technical matters.

(8) He is not a valuer, and in order to satisfy himself that any particular assets have been valued on a fair and reasonable basis, he is entitled to rely on the valuation certificates of those fully qualified by position, experience and qualification.

(9) It is his duty to ensure by proper verification that all the properties, assets and securities shown in the Balance Sheet did actually exist at that date, and that they have been properly valued.

(10) He should be particularly watchful to see that the liabilities in respect of purchases are not under-stated by the suppression of Invoices, and that all expenses relating to the period under audit although not paid are correctly brought in.

(11) Although an auditor is entitled to rely upon the certificate of some responsible official in regard to the stock-in-trade, he would be running considerable risks if he accepts the same without making due inquiries and using all reasonable and possible tests.

(12) An auditor should carefully examine the book debts, with a view to ascertaining that the reserve for doubtful debts is fully sufficient to meet all losses on debts doubtful of recovery.

(13) He is not justified in omitting to make personal inspection of securities which are in the custody of a person or company with whom it is not proper that they should be left.

(14) The work to be performed, and the explanations and information which may be required by the auditor are left to his discretion, but he cannot disassociate himself from responsibility by saying that the particular portion of work was not done by him, or that he did not ask for an explanation on a particular point.

(15) It is not his duty to give advice to the directors or the shareholders as to the mode of doing business.

(16) It is no part of his duty to take stock, or to act as a valuer.

(17) He is not bound to exercise more than reasonable care and skill in making inquiries and investigations, in the absence of any suspicious circumstances.

(18) He is not bound to approach his work with suspicion or with a foregone conclusion that there is something wrong.

(19) An auditor is not bound to assume when he comes to do his duty that he is dealing with fraudulent and dishonest people.

(20) An auditor will not be held liable for failing to detect ingenious and carefully planned schemes of fraud, when there is nothing to arouse his suspicions and when those frauds are perpetrated by the tried servants of the company and are undetected for years by the directors.

(21) He is justified in believing the tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care.

(22) An auditor is responsible for the form of presentation of the Profit and Loss Account of companies to the same extent as the form of the Balance Sheet, and unless both these statements are properly made out and presented, the shareholders cannot obtain a fair and correct view of the financial condition as also the true earnings of their undertaking.

(23) If any abnormal or extraneous credits are given in the Profit and Loss Account, the auditor would do well to insist on such items being clearly described and separately stated on the face of the accounts, so that the shareholders may have a correct view of the normal earnings of the company.

(24) If Secret Reserves are drawn upon for the purpose of augmenting current income, the auditor would be running grave risks if he did not disclose the fact in the accounts.

(25) In case of Holding Companies, only the dividends paid by the subsidiaries from the profits made subsequent to the purchase of their shares should be credited to Profit and Loss Account.

(26) If a Holding Company receives any dividends from a subsidiary company out of the Reserves or the Profit and Loss Account balance existing at the date of purchase of the controlling interest, the same should represent capital. If any such amounts are credited by the Holding Company to its Profit and Loss Account, the auditor must report the fact to the shareholders.

(27) An auditor must give the shareholders INFORMATION regarding the company's financial position in clear terms, and not the MEANS OF INFORMATION. An auditor who gives shareholders means of information instead of information, does so at his peril, and runs the very serious risk of being held judicially to have failed to discharge his duty.

(28) An auditor undertakes considerable responsibilities, and is liable for the proper discharge of his duties; and, if by the neglect of his duties.

or by want of reasonable care or sufficient fulfilment of duty, damage is caused to the company as such, he is responsible for that damage.

(29) When it is shown that the audited Balance Sheet did not indicate the true condition of the company, and that damage has resulted, the onus is on the auditor to prove that this is not the result of any breach of duty on his part.

(30) An auditor has no legal authority to call a general meeting where none is summoned by the Directors.

(31) If the Directors fail to summon a General Meeting, it is for the shareholders to insist on the statutory requirements being complied with, and not for the auditor.

(32) An auditor who certifies a Balance Sheet knowing it to be false is criminally liable.

(33) An auditor cannot escape personal responsibility by saying that the work was done by his clerk.

(34) An auditor should report to his employers upon all questionable matters, and his certificate should be clear, concise and free from all ambiguities.

(35) If he is not satisfied with the accounts he is certifying, he must report the fact to the shareholders.

(36) A misfeasance summons against an auditor can succeed only if it is affirmatively proved that the company sustained an actual loss by reason of the acts in respect of which the complaint is made.

(37) The duty of an auditor is discharged when he has fixed his signature to the Report attached to the Balance Sheet, and when he has sent that Report to the Secretary of the Company.

CHAPTER X

RESERVE, SINKING AND OTHER FUNDS

*As referred to in the Pro-forma Balance Sheet, under the
Indian Companies Act, 1913-1936.*

The object of this Chapter is to help the reader to come to some definite understanding as to the true significance of these items and their proper place in the Balance Sheet.

In the Form of Balance Sheet prescribed under the Indian Companies Act, 1913-1936, the various Funds of the Company appear on the liabilities side, immediately underneath the item Capital, as follows:—

“ Reserves ”

“ Any Sinking Fund ”

“ Any other Fund created out of Net Profits, including any Development Fund ”

“ Any Pension or Insurance Fund ”

“ Provision for Bad and Doubtful Debts ”

The Articles of Association of a company usually contain clauses as to the different classes of Funds to be created and maintained. In the absence of any special Article to this effect, clause 99 of Table A would apply, which contains the following:—

“ The Directors may, before recommending any dividend, set aside out of the profits of the company such sums as they think proper as a reserve or reserves which shall, at the discretion of the directors, be applicable for meeting contingencies, or for equalizing dividends, or for any other purpose to which the profits of the company may be properly applied, and pending such application may, at the like discretion, either be employed in the business of the company or be invested in such investments (other than shares of the company), as the directors may from time to time think fit.”

RESERVE FUND

A Reserve Fund may be defined as a sum set aside out of divisible profits and retained in order to provide for unexpected or unknown future losses, or to equalise dividends or to strengthen the financial position of the concern. In other words, it is a surplus created out of distributable profits representing the amount by which the assets of a concern exceed the sum of its paid-up capital and liabilities, provided the assets and liabilities are properly valued on the basis of a going concern.

A Reserve Fund cannot exist, side by side, with the debit balance of Profit and Loss Account. In the event of the Profit and Loss Account showing a debit balance at any subsequent date, the Reserve Fund must

automatically disappear to the extent of the deficiency, as otherwise, it would be a contradiction in terms to state on one side of a Balance Sheet, an item representing a deficiency on Profit and Loss Account, and on the opposite side, an item representing a surplus created out of Reserved Profits.

In the absence of special Articles to the contrary, the directors may transfer the whole or any portion of the Reserve Fund to the credit of Appropriation Account for the purpose of increasing the amount of profits available for dividends.

INVESTMENT OF RESERVE FUND

An idea seems to prevail that a Reserve Fund is improperly so called unless it is invested in ear-marked securities. This, however, is quite erroneous. Although in some cases it undoubtedly is very desirable to invest moneys in specific securities to represent the Reserve Fund, so that an easily realisable asset may be available when required, yet in reality the form of the assets has nothing to do with the existence of a Reserve Fund. A Reserve Fund may be merged in the general assets of the company. The only true test as to the existence of a Reserve Fund is (a) whether it is obtained by a reservation of profits which would otherwise have been distributed, and (b) whether it represents a clear surplus of assets over capital and liabilities. The question of employment of the amount representing the Reserve Fund—i.e., whether to invest it outside or employ it within the business, is a matter of policy for the management to consider with due regard to the financial condition of the business, and does not affect the reality of the Reserve Fund. If the concern is in need of more working capital, then it is clearly expedient that the surplus representing the "reserved profits" be allowed to remain in the business. For instance, where a company has an overdraft on which it has to pay 6 or 7 per cent interest, it would be sheer folly not to pay off such a liability but to lock up the Reserve Fund amount in gilt-edged securities yielding from 4 to 5 per cent interest. On the other hand, if it appears that an additional working capital cannot be usefully and profitably employed in the business, then the only proper and reasonable course would be to invest the reserved profits in gilt-edged securities outside the business.

RESERVES AND RESERVE FUND

The distinction between a Reserve Fund and a Reserve or a Reserve Account needs to be clearly drawn, as these terms are indiscriminately applied to items which are essentially different, thus giving rise to considerable confusion on the part of laymen. A Reserve or a Reserve Account is a provision for some KNOWN OR EXPECTED LOSS, such as, "Reserve for Bad Debts," "Reserve for Discounts," "Reserve for Repairs and Renewals," "Reserve for Disputed Claims," etc. It is not, therefore, a surplus—it is not represented by assets—and it is not available for dividends. While a Reserve Fund is formed as a result of appropriating profits, a Reserve Account is created by making a charge against Revenue before true profits can be

ascertained. Whereas it is impossible to create a Reserve Fund except out of divisible profits, a Reserve may be provided even during periods when a loss has been sustained. If these "Reserves" were designated "Provisions" and were always shown by way of deduction from the particular assets the loss on which they are intended to cover, no one could then mistake a "Provision for Bad Debts" or a "Provision for Renewals" for a Reserve Fund.

The prescribed Form of Balance Sheet requires the Provision for Bad and Doubtful Debts to be shown on the liabilities side and the Book Debts at the total book figure on the assets side. Debts considered good, doubtful and bad are, however, required to be distinguished in the inner column. It would have been much better if the Provision for Bad and Doubtful Debts were required to be shown as a deduction from the item Book Debts on the assets side, so that the net estimated realisable value of Book Debts could then have been seen at a glance. Similarly, Reserve for Discounts, if any, can best be shown by way of deduction from the item Book Debts, on the assets side of the Balance Sheet.

SINKING FUND

A Sinking Fund is a fund created with the object of providing means for the redemption of liabilities like Debentures or any other loan. It is found by setting aside, half-yearly or yearly, a fixed sum of money for a definite period, such sum to be invested at compound interest, so that at the end of the period, the annual amounts with accumulations of interests, will be sufficient to discharge a prescribed loan. In such a case, the amount set aside should not be debited to Revenue Account but to a Net Revenue Account or Profit and Loss Appropriation Account, as being rather in the nature of an allocation of profits than a charge against them.

The term Sinking Fund is often applied to what is really a provision for the replacement of a wasting asset, invested in liquid assets apart from the business, so that cash may be available at a time when the original asset has to be replaced without severely dislocating the concern. The amount thus set aside each year is a charge against revenue and not an allocation of profits. It would be clearer if the term Sinking Fund were used only in connection with the provision for the REPAYMENT of a future LIABILITY, and not in connection with the RENEWAL of an ASSET. The expression Replacement and Renewal Fund would be more appropriate in the latter case. If, however, it is desired to use the term Sinking Fund in either case, it may be suggested that the item be made a little bit more explicit in the Balance Sheet thus—"Sinking Fund for Redemption of Debentures" or "Sinking Fund for Replacement of Machinery," etc.

It would be clearly seen from the above that the essence of distinction between a Reserve Fund and a Sinking Fund lies in this, that whereas a Reserve Fund is maintained as a measure of prudence, the amount representing it may or may not be invested in outside securities as may be found

financially desirable, a Sinking Fund having been created to meet a known liability at a definite future date, should always be invested outside the business.

The advantages of maintaining a Sinking Fund quite distinct from a Reserve Fund are:—

(1) That it draws attention to the fact that investments representing this Fund have been acquired with the object of meeting a known liability at a definite future date, and cash to that extent should be readily available for the repayment of such liability on the due date; and

(2) That this Fund is not to be utilised for the purpose of equalising dividends, or for any other object than the one for which it was created.

DIVIDEND EQUALISATION FUND

This Fund is created by setting aside a portion of distributable profits in good years as a provision for less prosperous years, so that whenever the company may not make sufficient profits to enable it to declare the usual dividend, it may have recourse to this fund. The amount representing this fund need not necessarily be invested in outside securities. Even where there is no specific Dividend Equalisation Fund, a company can always draw upon its Reserve Fund, if any, for the purpose of equalising dividends.

RESERVE FOR REPAIRS AND RENEWALS

The object of such a Reserve is to equalise the charge against Profit and Loss Account for Repairs and Replacement of Machinery and Plant. The cost of repairs necessary to keep the machinery in proper working order naturally increases year after year, as the machinery grows older, and as a result thereof, although the concern gets equal benefit out of the use of this asset each year, the Profit and Loss Account is burdened with a heavier charge in respect of repairs and renewals during the latter years of the life of such asset. It is in order to equalise this charge to revenue, that some companies maintain a Repairs and Replacements Reserve. An average amount likely to be spent by way of repairs on the asset each year during its probable working life is estimated, and this fixed sum is charged to Profit and Loss Account each year and credited to Repairs and Replacement Reserve. The actual repairs of each year are, in this case, set off against this Reserve.

FIRE AND MARINE INSURANCE FUNDS

Instead of paying premia to insurance companies for insuring their assets against fire or marine risks, some companies insure their own risks and create reserves for this purpose. They, therefore, set aside each year such a sum as would represent an adequate premium for the amount of the risk covered, charging the same to Revenue and crediting it to Insurance Fund Account. A corresponding sum is then invested in gilt-edged securities which are ear-marked for this purpose. The balance of the Insurance Fund

goes on increasing till it represents a fair and reasonable reserve for the risks indicated. This reserve is, therefore, a provision against loss and not a general reserve, although it might in course of time partially represent the latter to the extent by which it would exceed the amount fairly and reasonably necessary for the purpose for which it was originally intended.

DEPRECIATION FUND

The item of Depreciation Fund which usually finds place on the liabilities side of a company Balance Sheet, does not appear amongst the Funds in the *pro forma* Balance Sheet. The reason is that under the heading of "Fixed Capital Expenditure" on the assets side, the Prescribed Form requires the total depreciation written off each asset to be shown by way of deduction from the original cost of that asset, in order to clearly indicate the net present value of each asset on the basis of a going concern, in the outer column. The principal advantage of this method is that it does not obscure the cost price of assets, which after a long term of years becomes rather difficult to ascertain, especially if renewals and, possibly, some reversing entries have been made. The separate depreciation account also allows an easy comparison of the amounts written off during the whole term.

Where the Depreciation Fund System is used to provide fund for the replacement of any asset, the corresponding Investments should be separately shown in the Balance Sheet under the distinct heading of Depreciation Fund Investments, so that these may not be apportioned towards any other purpose than the original.

INVESTMENT FLUCTUATION FUND

This item is usually to be found on the liabilities side of the Balance Sheet of Banks, Insurance Companies and other concerns which invest their surplus funds to a considerable extent in Public Funds and other gilt-edged Securities. This is a reserve created to provide for the loss by way of fluctuation in the values of these Investments. Under such a circumstance, the heading Investment Fluctuation Fund is quite misleading. It should be termed Investment Depreciation Account or Investment Fluctuation Account and must be shown by way of deduction from the Investments on the assets side.

To sum up the above, it may be laid down that a RESERVE is always a CHARGE AGAINST PROFITS and is created for any of the following purposes:—

- (1) To provide for an estimated loss on doubtful debts or discounts;
- (2) To meet depreciation on any asset and to provide for its future renewal;
- (3) To provide for loss in value of investments due to market fluctuations;

(4) To equalise the charge for repairs and replacements of machinery, etc.;

(5) To create and maintain the company's own fire or marine insurance fund; or

(6) To provide for disputed claims or any other loss which it is expected might occur, the amount of which is not yet known.

A RESERVE FUND, on the other hand, is an ACCUMULATION OF DIVISIBLE NET PROFITS set aside to serve any of the following purposes:—

(a) To retain some portion of the net profits when it is thought inexpedient to distribute profits up to the hilt;

(b) To enhance the financial stability of the company;

(c) To equalise dividends; or

(d) To provide for UNFORESEEN contingencies; and the equivalent amount may be used in the business or may be invested outside as the directors may deem expedient.

A SINKING FUND proper is created to provide for the REDEMPTION OF A KNOWN LIABILITY, and the amount represented by the same must always be invested outside the business. The corresponding debit in respect of Sinking Fund is always an ALLOCATION OF NET PROFITS and NOT a charge on the Profit and Loss Account.

CAPITAL PROFITS AND CAPITAL RESERVE

The following gains not having resulted from the usual course of trading and being of a capital nature are known as Capital Profits:—

(a) Any profit derived from the forfeiture and re-issue of shares.

(b) Profit derived from redemption of Debentures, in the open market, at a discount.

(c) Profits made from a business purchased prior to receipt of commencement certificate.

(d) Profits realised on sale of any fixed asset.

(e) Premium received on issue of shares or debentures.

Ordinarily, it would not be sound and proper to transfer such gains which have arisen from sources extraneous to the usual course of company's business to Profit and Loss Account so as to augment the divisible profits. Such items can more appropriately be credited to a Capital Reserve which can be utilised to meet any capital losses, or can be set off against abnormal revenue losses such as Preliminary Expenses, Cost of Issue of Debentures, Underwriting Commission or Brokerage on Shares, etc. There is, however, no legal objection to utilising such gains in distribution as dividends, in the absence of anything to the contrary in the company's Articles. Where such gains are brought into credit, the auditor must insist that they are shown distinctly on the face of the Profit and Loss Account so that they may not be mistaken for trading profits.

Sometimes, a Capital Profit is made by a company by way of appreciation in the value of its land, building or other fixed asset, or arising from the sale of any of its fixed assets. Such Capital Profits are transferred to Capital Reserve Fund. The question as to whether such Capital Profits are divisible has been settled in *Foster vs. The New Trinidad Lake Asphalt Company, Ltd.* In this case, it was decided that Capital Profits are available for distribution in shape of dividends, subject to the following conditions:—

(a) that the Memorandum and Articles do not forbid such a distribution, (b) that such profits are actually realised, and (c) that a surplus remains after a revaluation of the whole of the assets.

CAPITALIZATION OF RESERVES

Occasionally, in the case of a successful company, large reserves might have been accumulated out of profits as a result of the directors' policy not to distribute the whole of these, but to lay aside something to enable the company to meet any unforeseen contingency that may arise in the future, or to serve as so much more working capital to cope with the increasing business. Besides, the Reserve Fund may have accumulated to an amount far in excess of the present or the future needs of the company, and it would then be deemed desirable to give benefit of a part of such reserve to the existing shareholders by way of compensation for the loss of dividends which they have suffered. This desire on the part of the directors can be given effect to by a Bonus to shareholders payable from out of the Reserve Fund being proposed by the former and sanctioned by the General Meeting of Shareholders. Instead, however, of paying such bonus in cash and depleting the financial resources of the company, the same may be satisfied by the issue of additional shares considered as fully or partly paid up. Thus the company is enabled to capitalise a part of its reserves by issuing Bonus Shares in lieu of cash.

The capitalization of reserves by the issue of Bonus Shares benefits the company inasmuch as the past accumulated profits are permanently retained in the business. Further, where the Reserve Fund is allowed to get merged in the general assets of the company, the Bonus Shares would help to adjust the share capital to a figure more on a level with the actual capital employed in the undertaking. Where the profits and the consequent dividends are considerably large in comparison with the company's paid-up capital, the inference of profiteering naturally follows; but where the paid-up capital is increased by the issue of bonus shares, although the profits will remain practically at about the previous level, the percentage of dividend must necessarily be reduced, whereas the actual return to the individual shareholder will remain just the same.

The shareholders will have no occasion to be dissatisfied with such a procedure, as they can easily realise their Bonus Shares, if they so wish to.

Besides, the fact that the Company was enabled to issue Bonus Shares out of accumulated Reserves will tend to bring up the market value of those shares at a premium.

Capitalization of Reserves may be brought about in any one of the two ways:—

(1) By declaring a dividend or bonus to shareholders out of the Reserve Fund and utilizing the same in making the existing partly-paid shares fully paid; or

(2) By satisfying the bonus declared as payable from the Reserve Fund by the issue of new Bonus Shares considered as fully paid.

In the first case, the procedure followed is that a bonus is declared as payable to shareholders from the accumulated profits, which then becomes a debt due by the company. Simultaneously with this, a call is made on the shareholders to the extent of the uncalled balance on the shares. Now, instead of the company paying the bonus to the shareholders in cash, and the shareholders returning the money in satisfaction of the call made on them, the bonus amount due individually to each shareholder is set off by the company against the call money due from him.

In the second case, a bonus having been declared as payable from the Reserve Fund, the same, instead of being satisfied in cash, will be distributed in shape of new Bonus Shares considered as fully paid.

Where the Reserve Fund stands invested in outside securities and is not merged in the fixed assets, or cannot be usefully employed as additional working capital, the assumption would necessarily be that the existing share capital is sufficient for the present working of the business and that there is no scope for extension. In such a case, it would not be deemed to be sound finance to issue Bonus Shares from the Reserves, inasmuch as whereas the profits of the company would be constant and the number of shares having been increased, the rate of future dividend would necessarily have to be lowered, and might fall below the rate that would be deemed to be a fair commercial return, and this might impair the existing market value of the shares. A cash bonus would be more appropriate under such a circumstance, provided the company's liquid resources are sufficient for such purpose, and the reserve fund has reached a figure far beyond its legitimate limit.

Where, however, the profits already made by the company in the past have far exceeded the normal return on the capital employed, and in consequence the dividends declared so far have revealed excessive super-profits, it would seem wise to bring the rate of dividend down to a more equitable level by the issue of Bonus Shares from the Reserves.

It may be pointed out that undistributable profits, if retained in the business, may be employed either to serve as additional working capital where it can thus be usefully and profitably utilised in enhancing the profits, or may be sunk in extending the business by the purchase of additional plant

or other fixed assets. To the extent that such profits are used in the acquisition of fixed assets, they would further increase the productivity or other activities of the undertaking which fact in its turn would tend to add to its profit-earning capacity. The profits thus realised cannot legitimately be said to have been earned on the capital alone, with the result that the rate of dividend the company would be able to declare on its share capital would naturally be far in excess of any reasonable return. In such a case, the issue of Bonus Shares from the Reserves to the extent of the value of the fixed assets acquired from undistributed profits will be justified and will have the effect of bringing down the rate of dividend on the old and the new share capital to a fair level.

Thus it is that in many prosperous companies, bonus shares are issued from out of Reserves, for any one or more of the following reasons:—

(1) That where the Reserves have accumulated far in excess of the present or future probable needs of the company, the shareholders may be given some benefit thereout;

(2) That by bringing the issued share capital of the company in true relation to the capital actually employed in the business, the rate of dividend may be brought to a reasonable level, and as a result, the semblance of profiteering may disappear;

(3) To avoid exceptionally high profits and dividends from attracting competitors in the line where sole monopoly has so far been enjoyed;

(4) To prevent unduly high rates of dividends from dissatisfying their own employees who might feel to have been underpaid and might seek for a claim to higher wages;

(5) To prevent such excessive profits from disturbing the company's business by creating dissatisfaction amongst its own customers or suppliers.

Where any such bonus or dividend is declared, the auditor should see that there are profits available for distribution, and the dividend or bonus as proposed by the Directors is duly sanctioned by a resolution of the members. There can be no legal objection to such a procedure, as the declaration of the dividend or bonus would constitute the shareholders the creditors of the company, and their claims thus arising can be released by the company by either considering the call made on the existing partly-paid shares as having been satisfied from the Reserves or by the issue of new fully-paid shares. The auditor should inspect the Board's as also the Shareholders' Resolutions in this connection, and should ascertain that there is nothing in the company's Articles prohibiting the issue of Bonus Shares. The necessary entries in the financial records as also in the Share Registers should be checked. He should further see that the issue of new shares does not increase the share capital beyond the authorised capital, as otherwise, the necessary resolution for increasing the authorised capital would have to be passed. Finally, he should satisfy himself that all the statutory requirements in regard

to the filing of the necessary Return of Allotments and the payment of additional capital duty (where the authorised capital has been increased) have been duly complied with.

SECRET OR INTERNAL RESERVE

A discussion on the subject of Reserve and other Funds would be incomplete without bringing in that most debatable subject "Secret or Hidden Reserve." The term "Secret Reserve" is applied to a Reserve Fund, the existence of which does not appear on the face of the Balance Sheet. Where there is a Secret Reserve, the financial position of the concern is, no doubt, better than as appearing from the Balance Sheet.

Secret Reserves are created by writing down assets, such as Stock, Book-debts, Plant and Machinery and Premises below their true value, by making excessive provision for outstanding liabilities, by charging capital items to revenue, and by retaining appreciating assets at cost price.

Nearly all banks and financial concerns have their Secret or Hidden Reserves created with the object of equalising dividends, or to provide a fund out of which heavy losses can be met, without disclosing the fact to the shareholders and the general public. The effect of a Secret Reserve is to maintain the confidence of the customers and creditors by giving the impress of stability to a prosperous but fluctuating business, to check speculation in its shares, and avoid disclosing information to trade rivals. Another strong argument in favour of Secret Reserves is that the directors usually experience a sort of weakness on the part of shareholders to deny themselves a full distribution of profits in order to form Reserve Funds which are so very essential for the continued welfare of an undertaking.

The arguments against Secret Reserves are that such reserves being not disclosed in the Balance Sheet, the latter fails to accurately represent the true position of affairs; also that Secret Reserves might be used by unscrupulous directors for most improper purposes, for example, to cover up losses upon *ultra vires* transactions, or for the purpose of private speculations in the shares of the company.

THE AUDITOR'S POSITION AS REGARDS RESERVES

If the accounts are in order and disclose profits, an auditor cannot insist upon the creation of a Reserve Fund, as that is a matter outside his province, except in the case of a company where the Articles of Association specially provide for its creation.

Occasionally, the Articles specially direct that a fixed proportion of the profits shall be set aside to Reserve Fund each year, and often include special directors as to its investment. The auditor, in such a case, will have to see that the provisions in this respect are duly carried out.

If the Articles of the company expressly declare that the profits of each year are to be applied in certain proportions among the different classes of

shareholders, and contain no reference to a reserve fund, no part of such profits can be carried to Reserve Fund.

While dealing with amounts set aside to any Fund, the Auditor must have regard to the Resolutions of the Directors or Shareholders to see that such Resolutions are consistent with the company's Articles. If any portion of Reserve Fund is transferred by Directors to Appropriation Account with a view to increase the amount of profits available for dividends, the Auditor must see that the facts are made clear on the face of the accounts, and not in any way concealed. If the Reserve Fund is fictitiously created by an over-valuation of stock or by insufficient provision for bad debts or depreciation, it is his duty to disclose the fact in his report.

An auditor cannot demand that a Sinking Fund be created for the redemption of a liability such as debentures or other loans, except in the case of a company whose Articles provide for same or when the terms of issue of the debentures require the creation of such a Fund.

The auditor's position with regard to Secret Reserves is one of some little difficulty. Can an auditor certify the Balance Sheet of a company having a Secret Reserve as "exhibiting a true and correct view of the state of the company's affairs"? If a Secret Reserve is created for the good of the business, and therefore for the good of the shareholders, can the latter have any grounds for complaint against the auditor for having withheld from them certain information as to the complete and accurate state of the business? These are the questions an auditor has to face, and it is most important that he should enquire carefully into the object with which such Reserves are created. If the auditor is satisfied that such a reserve is necessary in the interests of the company and that it is used for *bona fide* purposes only, he may safely pass the matter without reference in his report. Some auditors, however, make a general statement in their audit report that the value of the assets is understated, thereby disclosing the fact that there is a Secret Reserve, but not showing its amount. If the auditor is not absolutely satisfied as to the *bona fide* of these transactions, he should without fail deal with the matter fully in his report to the shareholders.

The decision in the case of *Newton vs. Birmingham Small Arms Company, Ltd.*, is very important. The Birmingham Small Arms Company passed a special resolution altering their Articles of Association by inserting provisions that, in addition to providing an ordinary Reserve Fund, the directors might (without disclosing the fact) set aside sums out of profits to form an Internal or Secret Reserve Fund; that the Secret Fund need not, of course, be shown on the Balance Sheet and no information thereon need be given to the shareholders; that the directors might invest it as they thought fit, and might apply it for any purposes which they considered would advance the interests of the company; and that, while the particulars as to the fund were to be disclosed to the auditors, it should be the auditors' duty not to disclose any information with regard to it to the shareholders. In this case,

it was held by Buckley, J., that no Articles can deprive the auditor of his statutory right of reporting to the shareholders on all matters appertaining to the accounts of the company, and that Articles purporting to do so are void *ipso facto*.

The more recent and important case of the *Royal Mail Steam Packet Company* has thrown considerable doubts as to whether an auditor can accept the creation and maintenance of secret reserves without any comments, in all cases and under all circumstances. It seems clear, however, that when such reserves appear to be far in excess of the company's legitimate requirements, or are drawn upon for the purpose of augmenting the current year's income, an auditor would be running grave risks if he failed to disclose the existence of such a reserve or any such special credits openly on the face of the accounts, or alternatively to bring this fact to the knowledge of the shareholders in his report. The case has been considered at length on pages 255-259 in Chapter IX, and the student would do well to study the facts closely.

CHAPTER XI

PROFITS AVAILABLE FOR DIVIDENDS

The Balance Sheet of a Company is an important document in the eyes of the law, as it shows the financial position of the undertaking, and it is on this that the auditor reports to the shareholders. The Trading and Profit and Loss Account contains a summary of the revenue transactions of a particular trading period, but the net result thereof must be regarded as being subsidiary to the Balance Sheet. As, however, the ascertainment of true profits of a business as also the correctness of a Balance Sheet must necessarily depend on the values attached to the assets the question of how the assets should be valued requires the greatest attention at the hands of directors and the auditors. Further, there have been several important decisions at various times in connection with the valuation of assets for the purpose of arriving at divisible profits, and as they serve to indicate the legal view of the question, it has been thought necessary to devote this Chapter to a discussion of the various legal cases in this connection that have been brought before the English Courts.

The primary object of running any business undertaking is to earn profits and to distribute the same amongst its proprietors. Ordinarily, the profits of any accounting period may be taken to be the excess of the earning of such period over the revenue expenses or charges incurred in earning that income. In the ascertainment of such profits, however, most vital questions arise as to the inclusion or exclusion in the Profit and Loss Account of certain revenue charges such as provision for depreciation, reserves for likely losses; etc. Besides, whether capital profits, if any, should be included, and capital losses, if any, should be provided for the purpose of ascertaining divisible profits are further questions which call for proper solution. Then again, as to what expenses are properly chargeable to revenue, and what to capital is a matter on which it is impossible to lay down any general rules which could be applied with equal force in all cases and under all conditions. Such points at issue must necessarily be decided after taking into account the nature of the company's business, the Articles governing the determination and distribution of profits, and other peculiar circumstances obtaining in each particular case.

According to commercial practice, fixed assets should be valued at not more than their cost price, and as they depreciate or decline in value through use or effluxion of time, the estimated amount of such depreciation should be written off to Profit and Loss Account at the end of each financial period, in order that the income of that period may be burdened with the full cost to the business of earning such income. In so valuing these assets, any variation in their market value should necessarily be ignored. The reason is that the fluctuation in the market price of these assets from year to year does not affect the value of such assets to the business as a going con-

cern, inasmuch as they are acquired with a permanent object in view and not for the purpose of re-sale. On the other hand, floating assets (or circulating capital) should in all cases be valued at cost or market price, whichever is lower at the date of the Balance Sheet, as they are only held for re-sale or immediate conversion into cash. The legal position as regards the depreciation of fixed assets, however, is not altogether clear as the result of several cases on the subject.

Where a limited company is concerned, the one broad principle laid down by the Act, which should hold good in every case, is that no dividend can ever be paid out of the Capital of the company. The effect of this rule is that a dividend can only be paid out of a surplus resulting from trading, and that the capital, representing as it does a fund for the satisfaction of the claims of the creditors of the company in the event of a winding up, cannot be utilised in payment of dividends. Any Article contravening this fundamental principle of law will be *ultra vires* and will have no legal effect.

So far as the disposal of the profits is concerned, the Articles usually contain provisions authorising the directors to set aside from the amount available for dividend such sums as they may deem desirable to reserve and other funds, prior to any distribution. Under such a circumstance, the general attitude of the Courts, when approached by dissatisfied shareholders, has leaned against any interference with the domestic affairs of a company, unless it is shown by the complainants that the directors have not acted in the best interests of the company but with personal motives, or that they have acted with dishonest intentions or in contravention of the company's Articles or the general principles of law. In any case, the company's Articles of Association are of first importance while considering the question of divisible profits, and in cases where the Articles have definitely provided how the divisible profits should be determined and utilised, these must be rigidly adhered to in so far as they do not override the general principles of law.

The views expressed by the Courts in the several cases arising out of disputes as to what profits should be divided and what should not be divided are highly illuminating and instructive, and these being of considerable importance to the practitioners and students alike have been embodied herein as they are found to be worthy of serious study. It needs to be pointed out, however, that although the rules emerging from these decisions may serve as a most valuable guide, they are still lacking in their finality inasmuch as they must be taken as applicable to the specific cases concerned, and in future, each case will have to be considered on its own merits with due regard to the particular circumstances surrounding it.

Lee *vs.* Neuchatel Asphalte Co., Ltd., (1889)

In Lee v. Neuchatel Asphalte Co., Ltd., it was decided that where a company was formed to work a wasting asset and its Articles specifically stated that it was not necessary to provide for the depreciation of such asset, there was nothing in the Companies Act to compel it to do so.

In this case, an action was taken by Lee on behalf of himself and the ordinary shareholders of the defendant company, asking for an injunction restraining the company from declaring a dividend to the preference shareholders until depreciation on the company's property had been charged. The company had acquired a lease of mines in 1873, but before this had expired, it had been replaced by a new concession in 1877, which was to expire in 1907.

The Articles of the company provided that the directors should not be bound to reserve moneys for the renewal or replacement of any lease or interest in any property or concession; but provision had been made by writing off considerable sums, though nothing had been charged in respect of the old concession during the year in which the profit available had been made.

In giving judgment, Lindley, L.J., said:—

"The respondent company was formed for the purpose of working certain asphalte mines of which it had got a lease. It was quite obvious that with respect to such a property every ton of stuff got out of that which was bought with capital represented a portion of capital. It was said that a division of the profit arising from the sale of such was a return of capital. If that was so, it is not, at all events, such a return of capital as is prohibited by the Companies Act. There is nothing in any of the Companies Act prohibiting anything of the kind. . . . It has been very judiciously and properly left to the commercial world to settle how the accounts were to be kept. The Acts do not say what expenses are to be charged to Capital Account and what to Revenue Account. Such matters were left to the shareholders; they may or may not have a sinking fund or a deterioration fund; the articles of association may or may not contain regulations on these matters; if they do, the regulations must be observed; if they do not, the shareholders can do as they like so long as they do not misapply their capital. In this case, one of the articles provides that the directors shall not be bound to reserve moneys for the renewal or replacing of any lease or of the company's interest in any property or concession. . . . But if a company is formed to acquire or work property of a wasting nature, e.g., a mine, quarry, or patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficiently to pay its debts, any excess of money obtained by working the property over the cost of working it may be divided among the shareholders; and this is true, although some portion of the property itself is sold, and in one sense the capital is thereby diminished. If it is said that such a course involves payment of dividends out of capital, the answer is that the Acts nowhere prohibit such a payment as is here supposed. The proposition that it is *ultra vires* to pay dividends out of capital is very apt to mislead, and must not be understood in such a way as to prohibit honest trading. It is not true, as an abstract proposition, that no dividends can be properly declared out of moneys arising from the sale of property bought by capital. But it is true that if the working expenses exceed the current gains, profits cannot be divided, and that if in such a case capital is divided, and paid away as dividend, the capital is misapplied, and the directors implicated in the misapplication may be compelled to make good the amount misapplied. . . . In the present case the articles say that there need be no sinking fund; consequently, capital lost need not be replaced; nor, having regard to these articles, need any loss of capital by removal of bituminous earth appear in the Profit and Loss Account of the working of the company's property."

The points to be noted here are that the Court was only dealing with the wasting asset of a mining company, and that the decision was largely dependent upon the fact that the company's Articles clearly stated that the directors should not be bound to reserve moneys for the renewal or replacement of any property or concession. Besides, at the time of the proposed distribution of dividend, the assets of the company were of greater value than at the time of its formation.

It need hardly be pointed out that, if there are any provisions in the company's Articles to bring into account depreciation on fixed assets including even a wasting asset of the nature of a mine prior to ascertainment of divisible profits, such Articles would be valid and binding on the company.

Although profits may be legally distributed before making good losses or wastage of fixed assets under certain circumstances, yet from the viewpoint of sound commercial policy, it is highly desirable to provide sufficient reserves by writing off such losses against revenue, or by raising a Sinking Fund for their replacement out of distributable profits, in order to conserve the financial stability of the company. In case of companies working mines or quarries, however, the usual practice is not to provide for any replacement of the capital loss as represented by the exhaustion of the mines themselves out of current profits. The object of such undertakings is to work certain mines and then wind up when the ore is exhausted. The dividends thus declared without making any provision for wastage of mines would naturally be higher than the normal, and would represent partly income and partly a return of capital. If, on the other hand, an adequate amount in respect of depreciation of mines is charged to each year's Profit and Loss Account prior to distribution of profits, whereas such a step would considerably reduce the rate of annual dividend, the sum representing the depreciation written off each year will remain with the company and a sufficient fund would be accumulated by the time the mines have worked out, and the shareholders would then be returned their share capital on the winding up of the company. But, rather than allow large sums to be thus accumulated in the hands of the directors and wait for the return of their capital till the mines have exhausted and the company is wound up, the shareholders would naturally prefer to have the whole of the net working surplus distributed to them from year to year, in shape of dividends. The net working surplus, in such a case, would be represented by the excess of the sale proceeds of ore over the cost of working the mine each year, without making any provision for loss in capital value of the mine due to exhaustion of ore. It would seem, therefore, that in face of this established practice with mining companies, and in face of the fact that the shareholders are fully aware of the whole situation, and provided that the company's regulations do not contain anything to the contrary, and that sufficient assets are retained by the company for the payment of its debts, there is no occasion for the law to interfere.

Bolton vs. Natal Land & Colonisation Co., Ltd., (1891)

In the case of Bolton v. Natal Land and Colonisation Co., Ltd., it was held that a company may declare a dividend out of current profits without necessarily making good loss of capital assets.

In 1882, the company debited their Profit and Loss Account with £70,000 in respect of a bad debt, and at the same time, credited the Profit and Loss Account, with nearly an equal sum representing an increase in the value of its lands. In 1885, the company made a working profit and declared a dividend thereout. The plaintiff thereupon brought an action to restrain the payment of such dividend, on the ground that the company's lands had much depreciated in value, and that in order to arrive at distributable profits, it was necessary to write down the asset in question to its true value by charging the difference to Profit and Loss Account in the same way as the estimated increase in value had been credited to Profit and Loss Account in 1882.

The Court held that, assuming that a part of the capital had in fact been lost and not subsequently made good, no sufficient ground was thereby afforded for restraining the payment of the dividend; that the fact of the company having written up the value of their land in 1882 and credited the increase to the profit of that year in the manner described, did not place them under any obligation to bring into account in every subsequent year the increase or decrease in the value of their lands; and that, having regard to the case of *Lee vs. Neuchatel Asphalte Company, Ltd.*, it was not correct, in estimating the profits of a year, to take into account the increase or decrease in the value of the capital assets of the company.

The judgment may be taken as an extension of the decision in *Lee vs. Neuchatel Asphalte Company, Ltd.*, endorsing the legal view that, under certain circumstances, a company need not provide depreciation on its fixed assets prior to declaring a dividend. The legality of the action on the part of directors, in writing up the value of the land in 1882 to conceal a revenue loss in respect of the bad debt, was not considered by the Court, as the point was not raised by the pleadings.

It need hardly be stated that writing up the value of its capital assets and crediting unrealised values to Profit and Loss Account in one year and then ignoring their depreciation arising in subsequent years owing to excessive appreciation in the past, may not be illegal in some cases, but cannot, in any case, be said to be a measure of financial prudence.

Verner vs. General and Commercial Investment Trust, (1894)

It was decided in this case that, subject to its Articles, a Trust Company may distribute a dividend out of the excess of current revenue over current expenditure without making good the loss arising from diminution in the value of its investments.

The Company was formed with the object of investing its capital in Stocks, Shares and Securities of various description, and the income arising from these Investments was applied in paying dividends. In 1894, the market value of some of the Investments had fallen considerably and some Investments proved absolutely worthless, so that the value of the Company's assets had materially diminished. The Profit and Loss Account, however, showed that the income for the year considerably exceeded the expenditure for the same period. An action was brought to restrain the Company from declaring a dividend until the loss of capital assets was made good.

It may be noted that included in the Articles of the Company were the following clauses:—

“Subject to the rights of members holding share capital issued upon special conditions, the receipts of the company from the dividends, income, profits, bonuses and advantages payable or receivable in respect of the Company's investments shall be applicable as follows:—First, to the payment of a dividend for the particular year at the rate of 5 per cent per annum on the preferred stock; second, to the payment of such a dividend on the deferred stock as the same shall suffice to pay, and the trustees may, with the sanction of the Company in General Meeting, declare a dividend to be paid to the members accordingly.”

“The trustees may, before recommending any dividend, set aside out of the profits of the Company such sum as they think proper as a Reserve Fund to meet contingencies, or for equalising dividends, or for any other purposes of the Company; and may from time to time apply the whole or any part of such fund for any purposes of the Company.”

Part of the judgment by Lindley, L.J. and A. L. Smith, L.J. reads as follows:—

“The broad question raised by this appeal is whether a limited company which has lost part of its capital can lawfully declare or pay a dividend without first making good the capital which has been lost. I have no doubt it can—that is to say, there is no law which prevents it in all cases and under all circumstances. Such a proceeding may sometimes be very imprudent, but a proceeding may be perfectly legal and may yet be opposed to sound commercial principles. We, however, have only to consider the legality or illegality of what is complained of. As we pointed out in *Lee vs. Neuchatel Asphalte Company*, there are certain provisions in the Companies Acts relating to the capital of limited companies; but no provisions whatever as to the payment of dividends or the division of profits. Each company is left to make out its own regulations as to such payment or division. The statutes do not even expressly and in plain language prohibit a payment of dividend out of capital.

The capital of a company is intended for use in some trade or business, and is necessarily exposed to risk of loss. As explained in *Lee vs. Neuchatel Asphalte Company*, the capital even of a limited company is not a debt owing by it to its shareholders, and if the capital is lost, the company is under no legal obligation either to make it good or, on that ground only, to wind-up its affairs. If, therefore, the company has any assets which are not its capital within the meaning of the Companies Acts, there is no law which prohibits the division of such assets amongst the share-

holders. Further, it was decided in that case, and, in my opinion rightly decided, that a limited company formed to purchase and work a wasting property, such as a leasehold quarry, might lawfully declare and pay dividends out of the money produced by working such wasting property without setting aside part of that money to keep the capital up to its original amount. There is no law which prevents a company from sinking its capital in the purchase or production of a money making property or undertaking, and in dividing the money annually yielded by it without preserving the capital sunk so as to be able to reproduce it intact either before or after the winding-up of the company. A company may be formed upon the principle that no dividends shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital or assets up to a given value. But in the absence of some special article or contract, there is no law to this effect, and, in my opinion, for very good reasons. It would, in my judgment, be most inexpedient to lay down a hard and fast rule which would prevent a flourishing company either not in debt or well able to pay its debt from paying dividends so long as its capital sunk in creating the business was not represented by assets which would, if sold, reproduce in money the capital sunk. Even a sinking fund to replace lost capital by degrees is not required by law. It is obvious that dividends cannot be paid out of capital which is lost; they can only be paid out of money which exists and can be divided. Moreover, when it is said, and said truly, that dividends are not to be paid out of capital, the word "capital" means the money subscribed pursuant to the memorandum of association, or what is represented by that money. Accretions to that capital may be realised and turned into money which may be divided amongst the shareholders, as was decided in *Lubbock vs. British Bank of South America*; but, although there is nothing in the statutes requiring even a limited company to keep up its capital, and there is no prohibition against payment of dividends out of any other of the company's assets, it does not follow that dividends may be lawfully paid out of other assets regardless of the debts and liabilities of the company. A dividend presupposes a profit in some shape, and to divide as dividend the receipts, say for a year, without deducting the expenses incurred in that year in producing the receipts, would be as unjustifiable in point of law as it would be reckless and blameworthy in the eyes of businessmen. The same observation applies to payment of dividends out of borrowed money. Further, if the income of any year arises from a consumption in that year of what may be called circulating capital, the division of such income as dividend without replacing the capital consumed in producing it will be a payment of a dividend out of capital within the meaning of the prohibition which I have endeavoured to explain. It has been already said that dividends pre-suppose profits of some sort, and this is unquestionably true. But the word "profits" is by no means free from ambiguity. The law is much more accurately expressed by saying that dividends cannot be paid out of capital than by saying that they can only be paid out of profits. The last expression leads to the inference that the capital must always be kept up and be represented by assets which, if sold, would produce it; and this is more than is required by law. Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess, without deducting the capital which forms part of it will be contrary to law. . . . It is plain there is nothing in the Articles which requires lost capital to be made good before dividends can be declared. On the contrary, they are so framed as to authorise the sinking of capital in the purchase of speculative stocks, funds, and securities, and the payment of dividends out of whatever interests, dividends or other income such stocks, funds, and securities yield, although some of them are hopelessly bad, and the capital sunk in obtaining them is lost beyond recovery.

There is no suggestion of any improper juggling with the accounts, and there is no payment of dividend out of capital. There is no insolvency, and we have not to deal with a petition to wind up. Some capital is lost, but that is all that can be truly said, and that is not enough to justify such an injunction as is sought. The appeal must be dismissed."

The principle as summed up in the above judgment is very important as it is for the first time that a legal distinction is drawn therein between fixed and circulating capital, with a view to guard against a too literal interpretation of the decision. A clear distinction has been drawn by saying that fixed capital may be sunk and lost, and yet the excess of current receipts over current payments may be divided, but floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law. It is necessary, however, to point out that the principles laid down in *Lee vs. Neuchatel* and *Verner's* cases should always be regarded as limited in their application to the particular facts before the Courts for consideration, and, that in future, each case would be taken in connection with the particular circumstances surrounding it. It may also be noted that although these decisions show us what may be strictly legal or otherwise, it cannot be said that adherence thereto will always ensure the carrying on of the business on the soundest financial lines.

The judgment makes it clear beyond doubt that depreciation or loss on floating or circulating assets must be provided for before arriving at the profits available for dividend, but as to whether a company can lawfully declare a dividend before first making good the loss on its fixed assets must necessarily depend on the company's Articles. If the Articles do not definitely provide that loss on capital assets should be made good out of revenue before declaration of dividend, then there is nothing illegal in the company acting according to its own regulation, although such a procedure would be positively bad finance in a majority of cases.

Wilmer vs. McNamara & Co., Ltd., (1895)

In Wilmer v. McNamara & Co., Ltd., it was decided that a transport company could not be restrained from declaring a dividend out of current profits because no provision had been made for depreciation of fixed assets, viz., goodwill and plant.

The defendant company was formed to carry on the business of general carriers of mails, parcels, goods, etc. The ordinary shareholders of this company sought an injunction to restrain the directors from paying a dividend to the preference shareholders, on the ground that no provision had been made in respect of depreciation of the company's assets as disclosed by a recent valuation. The assets in question consisted of Goodwill, Leasehold Premises, Horses and Vans, Plant, etc. The Court held that a dividend could be paid out of current profits without replacing loss on fixed assets. In giving judgment, Stirling, J., said:—

"Clause 117 of the company's articles of association provides that no dividend shall be payable except out of the profits arising out of the business of the company. What are these profits? ... Apart from the use of the word 'profits' in Article 117, there is nothing in the articles to show that the capital of the company (or, rather, assets of the value of those acquired by the company at its formation) must be kept up. Further, the article appears to contemplate 'profits' as the excess of receipts over all expenditure properly attributable to the year. It is necessary, however, to consider whether the depreciation in goodwill and leasehold is to be treated as loss of fixed capital or of 'floating' or 'circulating' capital and on this point I am of opinion that it is to be treated as loss of 'fixed' capital. It very closely resembles the loss which a railway company may be said to suffer if it be found that their line, which was made, say, ten years ago at a certain cost could not be made at a much smaller cost. Having regard to the remarks of Lindley, L.J., in *Lee vs. Neuchatel Aspalte Company*. I think that the Balance Sheet cannot be impeached simply because it does not charge anything against revenue in respect of goodwill. I feel much more doubt whether £200 is a sufficient sum to allow in respect of depreciation of leaseholds, but I do not think under the circumstances that a case has been made out for an injunction."

Dovey vs. Cory, (1901)

In the case of *Dovey vs. Cory*, the House of Lords were considering the liability of a director for dividends improperly paid. It was held that a director acting in good faith is entitled to rely on the officers of the company to prepare true and honest accounts. The case is of importance as it has thrown some doubts on the finality of the decisions in *Lee vs. Neuchatel* and other cases. In the course of his judgment, Lord Halsbury, on the question of making good of capital losses, said the following:—

"I am very reluctant to enter into a question which for the reasons I have given does not arise here, and into which the Court of Appeal has entered at some length. The only reason why I refer to it at all is lest by silence I should be supposed to adopt a course of reasoning as to which I am not satisfied that it is correct. I doubt very much whether such questions can ever be treated in the abstract at all. The mode and manner in which a business is carried on, and what is usual or the reverse, may have a considerable influence in determining the question of what may be treated as profits and what is capital. Even the distinction between fixed and floating capital which in an abstract treatise like Adam Smith's *Wealth of Nations* is appropriate enough, may with reference to a concrete case be quite inappropriate. It is easy to lay down as an abstract proposition that you must not pay dividends out of capital, but the application of that very plain proposition may raise questions of the utmost difficulty in their solution. I desire, as I have said, not to express any opinion, but as an illustration of what difficulties may arise, the example given by the learned counsel in one ship being lost out of a considerable number, and the question whether all dividends must be stopped until the value of that lost ship is made good out of the further earnings of the company or partnership, is one which one would have to deal with. On the one hand, people put their money into a trading concern to give them an income, and the sudden stoppage of all dividends would send down the value of their shares to zero, and possibly involve its ruin. On the other hand, companies cannot at their will and without the precautions enforced by the statute reduce their capital; but what are profits and what is capital may be a difficult and sometimes an almost impossible problem to solve. When the time comes that these questions come before us in a concrete case we must deal with them, but until they do, I, for one,

decline to express an opinion not called for by the particular facts before us, and I am the more averse to do so because I foresee that many matters will have to be considered by men of business which are not altogether familiar to a Court of Law."

Davey, L.J., said:—

"I desire to express my dissent from some propositions of law which were laid down in the Court of Appeal, and upon which your Lordships thought it right to hear the respondents' counsel. The learned Judges seem to have thought that a joint-stock company, incorporated under the Companies Act, may write off to capital, losses incurred in previous years, and may in any subsequent year, if the receipts for that year exceed the outgoings, pay dividends out of such excess without making up the Capital Account. If this proposition be well founded, it appears to me that a company whose capital is not represented by available assets need never trouble itself to reduce its capital, with the leave of the Court and subject to the other conditions imposed by the Act of 1877, in order to enable itself to pay dividends, out of current receipts. My Lords, it may be that I have misapprehended the statement of law intended to be made by the learned Judges in the Court of Appeal. I think that is possible, because I find that in *Verner vs. General and Commercial Investment Trust* (1894, 2Ch. 124), 'Perhaps', Lord Lindley says, 'the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk or lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess in which case to divide such excess without deducting the capital which forms part of it will be contrary to law.' I reserve my opinion as to the effect of an actual and ascertained loss of part of the Company's fixed capital. . . . But, subject to this observation, I think that the statement of law in the passage I have quoted is not open to objection and it is only because the learned Judge appears to me to have departed from it in his judgment in the present case that I have troubled your Lordships with these remarks."

Bond *vs.* The Barrow Haematite Steel Co., Ltd., (1902)

In this case, it was held that Preference Shareholders cannot claim to be paid Dividends out of current profits as a matter of right and without regard to such provision for Reserves as the Directors may deem necessary to make as authorised under the Articles.

The Company's assets consisted of Furnaces, Lands, Cottages and Mines. The Company intended to supply itself with ore from the mines instead of buying it as required. The Mines were, however, flooded out and eventually had to be abandoned owing to the prohibitive cost of pumping out the water, and in consequence, the furnaces were pulled down and the cottages disposed off. The loss thus arising was charged against the Profit and Loss Account by the Directors, and an action was brought on behalf of the Preference Shareholders to compel the Directors to pay a dividend, the contention being that the loss need not be made good as it was a loss of fixed capital.

Farwell, J., in his judgment said:—

"I think that the money invested in those items is properly regarded in this company as circulating capital. Suppose the company had brought enormous stocks of ore sufficient to last ten years, it could hardly be said that the true value of so much of this as remained from time to time ought not to be brought into the Balance Sheet,

and I can see no difference for the purpose of the account between ore *in situ* and ore so bought in advance. The blast furnaces and cottages are mere accessories to the ore, and resemble a building for burning the stores bought in advance already mentioned. There is more difficulty about the remaining £50,000. I think that the onus is on the plaintiffs to show that it is fixed capital, and that in a company of this nature such fixed capital may be sunk or lost. They have not done this and the evidence, so far as it goes, is the other way. But this is not an actual loss, but depreciation by estimate. The plaintiffs really relied on *Lee vs. Neuchatel Asphalt Co.*, as an authority for this proposition as a universal negative; viz., 'that no company owning wasting property need ever create a Depreciation Fund.' In my opinion that is not the true result of the decision. It must be remembered that in that case there had been no loss of assets. The company's assets were larger than at its formation, and the Court decided nothing more than the particular proposition that some companies with wasting assets need have no Depreciation Fund. For instance, I cannot think that it would be right for the defendant company to purchase out of capital the last two or three years of a valuable patent and distribute the whole of the receipts in respect thereof as profits, without replacing the capital in purchase. It is for the Court to determine in each case on evidence whether the particular company ought, or ought not to have such a fund. There is no doubt as to the opinion of the witnesses in this case, and further, the opinion of the directors cannot be altogether disregarded. The Courts have, no doubt in many cases, overruled directors who proposed to pay dividends, but I am not aware of any case in which the Court has compelled them to pay when they have expressed their opinion that the state of the accounts do not admit of any such payment. In a matter depending on evidence and expert opinion, it would be a very strong measure for the Court to override the directors in such a manner."

This case demonstrates the danger which might be run in relying on the proposition "that a loss of fixed capital need not be made good" as being of general application, and that assets which might seem to be fixed assets from a commercial view-point may be regarded by the Courts as forming part of circulating capital. It further makes it clear that what was decided in *Lee vs. Neuchatel* was merely that some companies with wasting assets need not have any Depreciation Fund; and whether any particular company should or should not have such a fund, will be for the Court to determine, having due regard to the Memorandum and Articles of the company and other facts relating to each case. It also supports the theory that circulating capital, in whatever form it may be represented, ought to be maintained.

In Re The Spanish Prospecting Co., Ltd., (1910)

The meaning of the word "Profits" was discussed at some length in this case. The facts of the case were these:—The Company went into liquidation and all the creditors were paid out with the exception of two employees to whom arrears of salary were due. This salary was only to be payable to them provided the company made profits in the business. After all the creditors with the exception of these two claimants were paid out, and after the whole of the Subscribed Capital had been returned, there was a surplus in the hands of the liquidator which was claimed by the above employees.

The Court held that when a salary is payable only out of profits, and where arrears of such salary are payable out of succeeding profits, such profits need not necessarily be the profits shown by the annual accounts, but may include accretions of Capital, realised after liquidation.

In course of his judgment, Moulton, L.J., said:—

“The word ‘Profits’ has in my opinion, a well-defined meaning, and this meaning coincides with the fundamental conception of ‘profits’ in general parlance, although in mercantile phraseology the word may at times bear meanings indicated by the special context, which deviate in some respects from the fundamental signification. ‘Profits’ implies a comparison between the state of a business at two specific dates, usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.

“For practical purposes these assets in calculating profits must be valued and not merely enumerated. An enumeration might be of little value. Even if the assets were identical at the two periods, it would by no means follow that there has been neither gain nor loss because the market value—the value in exchange—of these assets might have altered greatly in the meanwhile. A stock of fashionable goods is worth much more than the same stock when the fashion has changed, and to a less degree, but no less certainly, the same consideration must apply to buildings, plant, and other fixed assets used in the business, because one form of business risk against which business gains must protect the trader is the varying value of the fixed assets used in the business. A depreciation in value, whether from physical or commercial causes, which affects their realisable value is in truth a business loss.

“We start, therefore, with this fundamental definition of ‘profits’, viz., if the total assets of the business at the two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowance, of course, being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question.

“But the periodical ascertainment of profits in a business is an operation of such practical importance as to be essential to the safe conduct of the business itself. To follow out the strict consequence of the legal conception in making out the accounts of the year would often be very difficult in practice. Hence the strict meaning of the word ‘profit’ is rarely observed in drawing up the accounts of firms or companies. These are domestic documents designed for the practical guidance of those interested, and, so long as the principle on which they are drawn up is clear, their value is diminished little, if at all, by certain departures from the strict definition which lessen greatly the difficulty of making them out. Hence certain assumptions have become so customary in drawing up Balance Sheets and Profit and Loss Accounts that it may almost be said to require special circumstances to induce parties to depart from them. For instance, it is usual to exclude gains and losses arising from causes not directly connected with the business of the company—such for instance, as arise in the market value of land occupied by the company. The value assigned to trade buildings and plant is usually fixed according to an arbitrary rule, by which they are originally taken at their annual cost and are assumed to have depreciated by a certain percentage each year, though it cannot be pretended that any such calculation necessarily gives their true value either in use or in exchange. These, however, are merely variations of practice by individuals. They rest on no settled principle. They mainly arise from the sound business view that it is better to underrate than to overrate the profits, since it is impossible for you to foresee all the risks to which a business may in future be

exposed. For instance, there are many sound businessmen who would feel bound to take account of depreciation in the value of business premises or in the value of plant especially designed for the production of a particular article, although they would not take account of appreciation in the same arising from like causes.

"To render the ascertainment of the profits of a business of practical use, it is convenient that the assets, of whatever nature they be, must be represented by their money value. But as a rule these assets exist in the shape of rights and not in the shape of money. The debts owed to the company may be good, bad or doubtful. The figure inserted to represent stock-in-trade must be arrived at by a valuation of the actual articles. Property of whatever nature it be, acquired in the course of business has a value varying with the condition of the market. It will be seen, therefore, that in almost every item of the account, a question of valuation must come in. In the case of a company like that with which we have to deal in the present case, the process of valuation is often exceedingly difficult, because the property to be valued may be such that there are no market quotations and no contemporaneous sales or purchases to afford a guide to its value. It is not to be wondered at, therefore, that in many cases companies that are managed in a conservative manner avoid the difficulty thus presented, and content themselves by referring to assets of a speculative type without attempting to affix any specific value to them. But this does not in any way prevent the necessity of regarding them as forming a part of the assets of the company which must be included in the calculations by which *de facto* profits are arrived at. Profits may exist in kind as well as in cash. For instance, if the business is, so far as assets and liabilities are concerned, in the same position that it was the year before, with the exception that it has contrived during the year to acquire some property, say mining rights, which it had not previously possessed, it follows that those mining rights represent the profits of the year, and this whether or not they are specifically valued in the accounts.

"But though there is a wide field for variation of practice in those estimations of profit in the domestic documents of a firm or company, this liberty ceases at once when the rights of third persons intervene. For instance, the Revenue has a right to a certain percentage of the profits of company by way of income-tax. The actual Profit and Loss Accounts of the company do not in any way bind the Crown in arriving at the tax to be paid. A company may wisely write off liberally under the head of depreciation, but they will be only allowed to deduct the sum representing actual depreciation for the purpose of calculating the profits for the purpose of income-tax. The same would be the case if a person had a right to receive a certain percentage of the profits made by the company. In the absence of special stipulations to the contrary, 'profits' in cases where the rights of third parties come in, mean actual profits, and they must be calculated as closely as possible in accordance with the fundamental conception of definition to which I have referred. I would have it clearly understood that these remarks have no bearing upon the vexed question of the fund out of which dividends may legally be paid in limited companies. Cases such as *Verner vs. The General Commercial Investment Trust* and *Lee vs. Neuchatel Asphalte Co.*, show that this fund may in some cases be larger than what can rightly be regarded as profits, and the decision in these cases depends largely on the fact that there is no statutory enactment which forbids it to be so."

Crabtree vs. Crabtree, (1912)

In this case, the Trustees were authorised to carry on the business left by the Testator and to give the profits arising therefrom to the Testator's wife during her lifetime. $7\frac{1}{2}\%$ depreciation on the original cost of the machinery was written off before the ascertainment of the net profits, and it

was contended by the life-tenant that such a charge should be disallowed. *It was held that such depreciation had been properly brought into account.*

Part of the judgment reads as follows:—

“But in the ordinary course of ascertaining the profits of a business where there is power machinery or trade machinery which is necessary in order to perform the work of the business, it is, in my opinion, essential that in addition to all sums actually expended in repairing the machinery, or in renewing parts, there should be also written off a proper sum for depreciation, and that sum ought to be written off before you can arrive at the net profits of the business, or at the profits of the business, and it is not profit until a proper sum, varying with the class of machinery has been written off for depreciation.”

“The only authorities referred to were those of companies formed to work a wasting property, and in such a case all profits arising from the wasting property are divisible without any deduction for the depreciation in value of the wasting property. That is because the object of the company was to acquire a wasting property and to divide all the profits. That is not so here. The profits of this business are not ascertained until a sufficient sum has been deducted to meet the depreciation of the machinery. One of the witnesses in his affidavit referred to the ‘saleable value’ of this machinery. That is not the right standard. Here it is the value of the machinery for the purpose of this business, not the saleable value.”

The above judgment makes it clear that in a manufacturing company where the capital equipment consists chiefly of plant and machinery, and where the object is to continue to trade indefinitely and not to stop work as soon as the original plant has become useless through wear and tear, a provision in respect of depreciation of machinery before arriving at the divisible profits becomes necessary each year during the working life of the asset, in order that a new asset may be acquired when the old one has to be discarded.

The Ammonia Soda Co., Ltd., *vs.* Arthur Chamberlain and others, (1918)

In the year 1910, the Company's Profit and Loss Account showed a debit balance of £12,970. For the purpose of the Balance Sheet issued by the company as on 31st July 1911, the value of the company's Land was appreciated by £20,542 as a result of re-valuation, and this helped to wipe off the debit balance on the Profit and Loss Account. The Company made profits subsequent to 31st July 1911 and paid dividends therefrom.

An action was brought by the plaintiff Company against the defendants who were the former directors of the Company, seeking to make the directors liable to refund the dividends already paid. It was contended by the plaintiffs that the re-valuation was not a genuine one, but was made simply with a view to wipe off the past debit balance on the Profit and Loss Account, which should have been written off first out of the subsequent profits prior to the payment of dividend.

It was held that a Company may write up the value of its assets as a result of a bona fide valuation and may distribute current profits without first making good past losses.

Part of the judgment reads as follows:—

"The directors in my view honestly entertained the view that the land in 1911 had largely increased in value, and the plaintiff Company in general meeting adopted their views, knowing that the valuation had been made by the directors, and knowing, as they must have known, that the directors who had made the valuation were not professional valuers or men who had had a long experience in the salt business."

"There is not any ground for suggesting that any facts were concealed from the shareholders by the directors. In these circumstances it is not, in my opinion, open to the company to attack the directors for an honest, though it may be erroneous, estimate which has been expressly adopted by the company in general meeting after the attention of its shareholders had been pointedly called to the resolution by the auditors' certificate which was attached to the Balance Sheet."

"It was contended, however, that there was no justification for the payment of the dividends in question, even if the valuation was honest and even if in its result it was correct. Mr. Gore-Brown said that the essential question was whether or not capital assets could be written up so as to justify payment of a dividend, that the valuation, however careful and however thorough and satisfactory to the Court, was not a justification for paying dividends, that the Profit and Loss Account was a continuous account which was always open, and that there was no profit on it until all past losses had been worked off....

"There is one distinction which should, I think, be remembered for the purposes of the present case. A dividend may be improper because it is paid out of capital, or it may be open to objection because it is paid when there are no profits available for the purpose. If during the year there is no balance to the credit of Profit and Loss Account, any dividend which is paid must be pointed out as paid out of capital and any such payment must reduce the paid-up capital....

"But where a company has made losses in past years and then makes a profit out of which it pays a dividend, the question is a different one. Such a dividend is not paid out of paid-up capital. If it were, the paid-up capital would be still further reduced by the payment. In fact the assets representing the paid-up capital remain the same or of the same value as before the payment of the dividend. It may be that the balance to the credit of Profit and Loss Account ought to be applied in making up lost capital and it may be that the directors are liable for neglecting to apply it in this way. But such a payment does not involve a reduction of capital, it involves a failure to make good capital which has already been lost.

"In the present case, the dividends in question were not paid out of capital, if the word capital is used as meaning assets which at the time, in fact, represented paid-up capital. They were, in fact, paid out of the balance standing to the credit of Profit and Loss Account for the years in which they were paid. The question in this case, therefore, is whether any profits which were made had to be applied in making good any losses of previous years, and whether an increase in the value of the fixed capital could be taken into consideration for the purpose of wiping out previous losses of paid-up capital....

"As the Law stands at present, losses of circulating capital must be made good before there are any profits out of which dividends can be declared; but having regard to the observations of Lord Davey in *Dovey vs. Cory*, the question whether a similar rule applies in the case of fixed capital appears to be still open.

"I am not satisfied that the proposition that it is contrary to all principles of commercial accountancy to utilise an increase in the value of a fixed asset for the purpose of getting rid of a debit which represents loss of paid-up capital is not too wide. It

may be a precept of prudence and yet be far removed from the sphere of the categorical imperative. Assuming that a company ought to keep the value of its assets up to the amount of the liabilities and paid-up capital, or, in other words, to see that its paid-up capital is intact, why should it be absolutely precluded from stating the true value of its assets?

"In my judgment, then, the present action fails and must be dismissed with the usual consequences."

From the above judgment it seems clear that a company is not bound to make good previous debit balance on the Profit and Loss Account before dividing current profits. The payment of dividend out of current profits, without making good past losses does not necessarily amount to payment of dividend out of capital. From the view-point of sound finance, it may seem desirable to apply current year's profits in making up lost capital; but legally, if it is not so applied and utilised in payment of a dividend, it will not amount to a reduction of capital. There is thus no legal obligation to provide for lost capital out of current profits.

The circumstances under which capital profits would be available for distribution as dividends were considered in the following important cases:—

Lubbock *vs.* The British Bank of South America, Ltd., (1892)

The company was carrying on banking business and made a profit of £205,000 on the sale of its goodwill and property in Brazil to another Bank. The directors proposed to distribute the sum as dividend, and a motion was brought by the plaintiff on behalf of himself and all the other shareholders to restrain the Company from carrying into effect a resolution passed by the directors.

It was held that the £205,000 was plainly profit on capital and not part of the capital itself for that sum was the surplus ascertained on the assets side after the liabilities and capital were placed on one side of the account and the assets on the other. Under the Articles of the company, the directors were justified in carrying over the £205,000 to a Profit and Loss Account, and having appropriated to the Reserve Fund so much of the sum as they thought fit, they could distribute the remainder as dividends after an ordinary meeting called in pursuance of the Articles had passed the requisite resolution.

Foster *vs.* The New Trinidad Lake Asphalt Co., Ltd., (1900)

In this case, it was decided that the profit made on the realisation of an asset taken over by a company on its formation is not available for Dividend, even though such asset be a book debt, without due regard to the value of the assets as a whole.

The defendant company had taken over from another company, amongst other assets, a book debt of \$100,000 secured by Promissory Notes. The debt was then regarded as of no value, and it was, therefore, not shown

as an asset in the company's books. The Promissory Notes, however, subsequently realised £26,000 odd, and the directors proposed to treat this amount as profit available for dividend. The debenture-holders brought an action to restrain the company from utilising this amount in distribution as dividend, and it was held that such dividend could not be paid without making a re-valuation of all the assets and liabilities of the company.

Part of the judgment reads as follows:—

"It appears to me that the amount in question is *prima facie* capital, and that I have no evidence which would justify me in saying that it has changed its character because it has turned out to be of greater value than had been expected. . . . It is clear, I think, that an appreciation in total value of capital assets, if duly realised by sale or getting in of some portion of such assets, may in a proper case be treated as available for purposes of dividend. This I think, is involved in the decision in the case of *Lubbock vs. British Bank of South America*, cited with approval by Lord Lindley in *Verner vs. General and Commercial Investment Trust*, where he says:—"Moreover, when it is said, and said truly, that dividends are not to be paid out of capital the word 'capital' means the money subscribed pursuant to the memorandum of association, or what is represented by that money. Accretions to that capital may be realised and turned into money, which may be divided amongst the shareholders, as was decided in *Lubbock vs. British Bank of South America*." If I rightly appreciate the true effect of the decisions, the question of what is profit available for dividend depends upon the result of the whole accounts fairly taken for the year, capital, as well as profit and loss, and although dividends may be paid out of earned profits in proper cases, although there has been a depreciation of capital, I do not think that a realised accretion to the estimated value of one item of the capital assets can be deemed to be profit divisible amongst the shareholders without reference to the result of the whole accounts fairly taken."

It will be seen from the decisions in the above two cases that a Capital Profit can only be regarded as available for dividend, provided the following conditions are fulfilled:—

- (1) That the Articles of Association do not prohibit such a distribution;
- (2) That such profit is actually realised; and
- (3) That the surplus exists after a re-valuation of all the assets and liabilities, including the capital.

The above precautions seem to be very reasonable in order to prevent the presentation of artificial profits as a result of re-valuation. Mere revaluation, however accurately arrived at at the time, may not be permanent, and if the temporary excess over book values be distributed and if the market values of such assets fell at a subsequent date, then there will be no opportunity of such loss being made good except out of current profits. It has, therefore, been rightly laid down that a distribution of such capital profit can be made provided they are actually realised. Then again, it is neither desirable nor sound that a realised surplus resulting from the sale of a single asset be distributed. Other capital assets may have depreciated, and in order to leave the capital fund intact before any surplus of this type be distributed, it is necessary that a surplus be left on a re-valuation of the whole of the assets of the company.

Wall vs. London & General Provincial Trust Co., Ltd., (1920)

The defendant company was formed to carry on the business of buying and selling investments. The company's Articles included amongst others the following provisions:—

"The board might in any year, after $4\frac{1}{2}$ per cent had been paid on the preference stock and 4 per cent on the ordinary stock, carry to General Reserve Account such sum as they might deem expedient for the equalisation of dividend or payment of losses."

"No dividend or instalment of dividend or bonus should be payable except out of the net profits arising out of the business of the company."

"All profits and losses resulting from any change of investment should be carried to Capital Reserve Account, and any such profits or losses should be disregarded in estimating the net profits."

The company purchased some of its own Debentures on the market on a certain date as they were quoted then at a considerable discount. A substantial amount of profit was thus made, and at the same time, this reduced the company's liability. The directors proposed to distribute this profit and an action was brought by the plaintiff to restrain the Company from so doing.

It was held that, having regard to its Articles, the company cannot treat profits made on redemption of its Debentures as being available for Dividend. The view taken by the Court was that the company could not regard such a profit in the nature of a revenue profit as it resulted from the extinction of the company's own liabilities.

If the Company's Articles had allowed the use of Capital Profits for the distribution of dividends, there would have been no legal objection to the distribution of profits arising on the redemption of debentures.

Stapley vs. Read Bros., (1924)

In this case, the company had been appropriating some of its profits for some years past towards reducing the value of Goodwill with the result that the whole of the Goodwill Account amounting to £1,40,000 disappeared from the company's books. In the year 1922, the Profit and Loss Account showed a debit balance of £20,504. In 1923, the company made a net profit of £13,430, and the directors proposed to utilise this amount in paying the dividends on Cumulative Preference Shares for the years 1921, 1922 and 1923 which were in arrears. To enable them to do so, they proposed that the value of Goodwill be restored in the company's books to the extent of £40,000 by debiting Goodwill Account and crediting the Reserve Account, and to wipe off the former debit balance on Profit and Loss Account, by transfer to the above Reserve Account.

The action was brought with a view to restrain the payment of these dividends on the ground that the profits originally applied towards writing off the value of Goodwill should not be written back on subsequent occasion.

It was held that for the purpose of declaration of dividends out of the profits earned in a particular year, it was not necessary to make good the previous debit, if any, standing on the Profit and Loss Account, the Court in this respect affirming the decision in the *Ammonia Soda Co. vs. Chamberlain*. It was further held that the writing off of the Goodwill out of the profits in the previous years did not amount to a permanent capitalisation of such profits and that the Company was not precluded, in any subsequent year, from writing back to Goodwill Account, a sum not exceeding its then fair value, by giving a corresponding credit to Profit and Loss Account and treating such profit as available for dividend. This is provided there is nothing in the constitution of the Company prohibiting such a procedure.

The important point to be noted here is that it was admitted that the Goodwill of the business was really worth £40,000 at the time the company wrote this amount back to Goodwill Account.

CONCLUSIONS

From the above expressions of the judicial views, it seems that the question of what profits can be legally divided will have to be decided in each case on its own merits. The following conclusions may, however, be drawn as a safe guide:—

(1) A dividend pre-supposes a trading profit or a surplus, but in certain cases, divisible profits may include profits of a capital nature.

(2) The Company Law does not require a company to maintain its capital intact, but merely forbids any part of the capital to be returned to its shareholders.

(3) Neither the sanction of a General Meeting nor an express authority in the Memorandum or the Articles can justify the payment of a dividend out of capital.

(4) The question of how "Divisible Profits" should be arrived at is left by law for each company to decide for itself with due regard to the nature of its business and the regulations governing it.

(5) If a company paid dividends in any one year out of a credit balance on Profit and Loss Account of that year properly arrived at, then such dividend is not paid out of Capital.

(6) Depreciation or loss on Floating or Circulating Assets must always be made good before the payment of a dividend.

(7) Depreciation of Fixed Assets need not necessarily be provided for before the payment of a dividend; but as to whether such a provision is necessary or not will be a question of fact, to be determined by the Court, with due regard to the nature of the company's business, the regulations of the company concerned, and other circumstances.

(8) In case of a manufacturing concern, due provision must be made for Depreciation of Plant and Machinery before ascertainment of divisible profits.

(9) Unless so required by its Articles, a company formed to work a wasting asset need not necessarily provide for depreciation of such asset before arriving at divisible profits.

(10) Any provision in a company's Articles requiring depreciation or particular losses to be made good prior to ascertainment of divisible profits are valid and binding, and must be strictly followed.

(11) Whether it is necessary or not for a company to replace capital previously lost before distributing the current profits, depends entirely on the company's own regulations; but the company must retain sufficient assets to enable it to pay off its debts and liabilities while declaring dividends.

(12) Assets may be re-valued, provided it is done honestly and with the approval of the shareholders. An asset that may have been over-depreciated in the past may be written up, and the surplus thus arising may be utilised in writing down another asset, in order that the book value of each may be brought nearer the present value.

(13) Capital profits, if realised, may be distributed as dividend, unless the Articles forbid such a procedure, but in such a case, the credit to the Profit and Loss Account must be specifically shown so that it may not be mistaken for trading profit.

(14) Any appreciation in the value of fixed capital of a Limited Company can only be distributed, if after a re-valuation of all the assets and liabilities of the company, there is a distinct surplus over the capital; it is equally necessary to see that such capital profit is realised in cash, and the regulations of the company do not prohibit such a distribution.

(15) Directors authorising the payment of a dividend out of capital are guilty of a breach of trust, and are jointly and severally liable to repay the amount.

(16) Directors and auditors who help in the declaration of a fictitious dividend by the publication of false accounts are criminally liable.

CHAPTER XII

AUDITS OF BANKS & INSURANCE COMPANIES

FRESH PROVISIONS REGARDING BANKING COMPANIES.

The Indian Companies (Amendment) Act, 1936, has introduced new provisions for the first time regarding Banking Companies.

Section 277F defines a Banking Company as one which carries as its principal business the acceptance of deposits of money on current accounts or otherwise, subject to withdrawal by cheques, drafts, or otherwise. It may also engage in various other kinds of business usually carried on by banks and which are specified in the same section. Section 277G limits the activities of Banking Companies to the business defined in the Section 277F. In the case of existing companies, these provisions will come into force two years after the commencement of this Act.

Section 277H prohibits the employment of a managing agent by any Banking Company two years after the commencement of this Act.

MINIMUM PAID-UP CAPITAL

Section 277I prohibits the starting of business by any new Banking Company unless at least a paid-up capital of Rs. 50,000 is raised, and a declaration to that effect signed by the directors and the manager is filed with the Registrar. This Section thus ensures the receipt of adequate working capital before the commencement of business by any Bank.

PROHIBITION OF CHARGE ON UNPAID CAPITAL

Section 277J prohibits and makes invalid any charge upon the unpaid capital of any Banking Company.

COMPULSORY MAINTENANCE OF A RESERVE FUND

Section 277K requires every Banking Company to maintain a reserve fund and credit thereto not less than 20 per cent out of each year's profits till such fund equals the paid-up capital of the company. This fund must be invested in Trustee Securities or deposited in a special account with a Scheduled Bank. In case of existing Banking Companies, this provision will come into force after two years from the commencement of this Act.

Section 277K. (1) Every banking company shall, after the commencement of the Indian Companies (Amendment) Act, 1936, maintain a reserve fund.

(2) Every banking company shall out of the declared profits of each year and before any dividend is declared transfer a sum equivalent to not less than twenty per cent of such profits to the reserve fund until the amount of the said fund is equal to the paid-up capital.

(3) A banking company shall invest the amount standing to the credit of its reserve fund in Government securities or in securities mentioned or referred to in section 20 of the Indian Trusts Act, 1882, or keep deposited in a special account to

be opened by the company for the purpose in a scheduled bank as defined in clause (e) of section (2) of the Reserve Bank of India Act, 1934 :

Provided that the provision of the sub-section shall not apply to a banking company incorporated before the commencement of the Indian Companies (Amendment) Act 1936, till after the expiry of two years from the commencement of the said Act.

COMPULSORY CASH RESERVE

Section 277L requires every Banking Company to maintain a cash reserve equivalent to at least one and half per cent of its TIME LIABILITIES and five per cent of its DEMAND LIABILITIES.

Section 277L. (1) Every banking company shall maintain by way of cash reserve in cash a sum equivalent to at least one and a half per cent of the time liabilities and five per cent of the demand liabilities of such company and shall file with the registrar before the tenth day of every month a statement of the amount so held on the Friday of each week of the preceding month with particulars of the time and demand liabilities of each such day.

(2) For the purposes of sub-section (1) 'demand liabilities' means liabilities which must be met on demand, and 'time liabilities' means liabilities which are not demand liabilities.

(3) Nothing in this section or in section 277K shall apply to a scheduled bank as defined in clause (e) of section 2 of the Reserve Bank of India Act, 1934.

(4) If default is made in complying with the requirements of section 277G, section 277H, section 277J, section 277K or section 277M or with the requirements of this section as to the maintenance of a cash reserve, every director or other officer of the company who is knowingly and wilfully a party to the default shall be liable to a fine not exceeding five hundred rupees for every day during which the default continues, and if default is made in complying with the requirements of this section as to the filing of the statement referred to in sub-section (1), to a fine not exceeding one hundred rupees for every day during which the default continues.

Sections 277I, 277J, 277K and 277L are important to the auditors as they relate to matters pertaining to accounts, and it would be the duty of the auditor to ascertain that all the requirements of the sections are duly complied with.

INTERNAL CHECK BY OWN AUDIT STAFF

As the transactions of a Bank are usually vast and voluminous, it is not possible for a Bank Auditor to perform a detailed audit covering the whole of the transactions, and he will, therefore, have to depend to a considerable extent on the system of Internal Check obtaining in the concern. Besides, as every Bank of any importance has its own system of Internal Control and Audit, a detailed audit of the daily transactions by the auditor on behalf of the shareholders is not necessary.

As the accuracy of the record of the transactions of any bank would depend so much on the system of Internal Control and Check in use, it is

indispensably necessary that its internal working must be highly organised.

The main features of any such system must necessarily be as under:—

(1) The Cashiers should have no access to the Ledgers, nor should the Ledger-keepers have anything to do with the Cash Books.

(2) The duties of the clerks should be shifted about from time to time.

(3) There must be a system of calling over of the record of the whole of each day's transactions by sets of clerks independently of those who wrote them up.

(4) There should be a day-to-day check of the Clearing House transactions.

(5) The Bills Department should be under the control of an inspector whose duty would be to closely scrutinise the daily incomings and outgoings of bills.

(6) At short periodical intervals, the balances on Current and Deposit Ledgers as also Loan Ledgers should be checked by responsible officials.

(7) There should be a regular checking of the Pass Books with their corresponding Ledger Accounts by special inspectors, and neither the Cashiers nor the Ledger-keepers should have anything to do with such checking.

(8) There should be a complete Internal Control over the whole of the Securities lodged with the bank either in respect of Overdrafts, Cash Credits, Fixed Loans or any other account, and these should be verified by inspection by some authorised person from time to time.

(9) The Securities lodged by customers in Safe Custody should also be verified by some person in authority from time to time.

(10) There should be a constant reconciliation of the Current Account Ledgers, Fixed Deposit Ledgers, Loan Ledgers and Security Registers with their corresponding Control Accounts in the General Ledger, by the internal audit staff.

(11) Branch Offices should be given surprise visits by travelling auditors or inspectors who should report periodically to the Head Office.

(12) A day-to-day complete record should be maintained of the checkings and inspections performed by the internal audit staff.

(13) All discrepancies discovered should be immediately set right.

(14) Any irregularities detected should at once be reported to the chief manager so that immediate investigation may follow.

The above rules will have to be rigidly enforced, and if the duties of each member of the internal audit staff are duly performed, the auditor need not concern himself with the detailed checking of daily record. The first duty of an auditor for the purpose of certifying a Bank Balance Sheet would, therefore, be to carefully study the regulations pertaining to the Internal

Check and Audit in force, and ascertain how far these have been faithfully carried out, before commencement of his work. He should then frame his own plan of procedure and determine upon the work he will have to perform.

SPECIAL FEATURES IN BANK AUDIT

The special features in the Audit of a Bank are:—

(1) To attend at the bank on the last day of the financial close and count or weigh cash, notes, postal orders, cheques, etc., forming the cash balance in hand on that date.

(2) Obtain certificates for Cash deposited with other Banks.

(3) Verify the cheques, drafts, etc., received too late on the date of the financial close for clearing, and ascertain that these are duly cleared within the next few days.

(4) Examine Bills unmatured and on hand, and see that proper provision is made in respect of overdue or doubtful bills.

(5) See that Rebate on Bills discounted and unmatured is duly carried forward on the same basis as in the previous year.

(6) Check the balances of the Current and Fixed Deposit Ledgers on to the Schedules, and see that the totals of the Schedules agree with the balances of the respective Total Accounts in the General Ledger.

(7) Check the balances of Loan Ledgers on to the Schedules, and see that the totals of such Schedules tally with the balances on the respective Total Accounts in the General Ledger.

(8) Inspect the Securities deposited by customers against Loans, Overdrafts and Acceptances, and see that all such loans are duly covered.

(9) Examine the Bank's Investments as per the Investment Ledger. Enquire into the basis of valuation. See that proper provision is made for fall in market value, if it happens to be lower than the cost.

(10) Ascertain whether the income from each investment is duly accounted for as received, and that all interest accruing to date of Balance Sheet is taken credit for.

(11) See that all interest payable on Fixed or other Deposits is duly provided for up to the date of Balance Sheet.

(12) Check a certain proportion of Securities held for Safe Custody and Collection of Dividends with the corresponding Registers.

(13) See that the Branch Returns are certified by the respective Branch Managers, and are properly incorporated in the Head Office books.

(14) Enquire if Pass Books are inspected by some responsible official and initialled by him once at least every half year. Examine a few of the Pass Books to satisfy yourself on this head.

(15) Check totals of the balances of the subsidiary Ledgers to see if they agree with their corresponding General Ledger Balances.

(16) Check the General Ledger Balances into the Final Accounts.

(17) Keep a note of all Assets and Securities written off for purposes of Secret Reserve.

(18) Ascertain that all likely losses on accounts doubtful of recovery are duly provided for.

(19) Scrutinise carefully the transactions in foreign currencies and see how these have been assimilated in the Head Office Books.

(20) See that Loans and Advances fully secured are properly distinguished from those partly secured and unsecured, and are duly set forth in the Balance Sheet.

(21) In regard to balances on Loan Accounts, see that the limits, if any, imposed, are not exceeded.

(22) See that all liabilities at the date of financial close are brought into account.

(23) Ascertain by verification and inspection that all the securities and other assets as shown in the Balance Sheet actually existed and that they have been properly valued.

PARTICULARS OF LOANS AND ADVANCES ON BALANCE SHEET

The Indian Companies Act, 1913-1936, requires the following particulars to be disclosed on the face of a Bank Balance Sheet in connection with Loans and Advances, and the auditor should ascertain that the information given accurately represents the true state of affairs.

Particulars of Loans and Advances:—

(1) Debts considered good and in respect of which the Bank is fully secured.

(2) Debts considered good, secured by the personal liability of one or more parties as under:—

(a) Debts due on Bills discounted,

(b) Debts due on joint and several Promissory Notes,

(c) Debts due on Temporary Overdrafts, Cash Credits and Personal Securities, etc.

(3) Debts due by Directors or other Officers of the Bank.

(4) Debts due by Directors of the Bank jointly with other persons or on securities and considered good, including debts due by Joint Stock Companies guaranteed by their Agents where a Director of the Bank is a Partner or a Director of the Firm of Agents of the borrowing Company, or is a guarantor, and

(5) Debts considered Doubtful or Bad.

REPORT OF AUDITORS TO THE SHAREHOLDERS

The usual form of the Report of Auditors to the Shareholders at the foot of a Bank Balance Sheet would run as under:—

“We have audited the above Balance Sheet of the.....Bank, Ltd., as at....., and also the above Profit and Loss Account of the Bank for the half-year ended upon that date, in which are incorporated the authenticated Returns from Branches, and report that:—

(a) We have obtained all the information and explanations we have required; (b) in our opinion, the above Balance Sheet and Profit and Loss Account are drawn in conformity with law; (c) such Balance Sheet exhibits a true and correct view of the state of the Bank's affairs according to the best of our information and explanations given to us and as shown by the books of the Bank, and (d) in our opinion, books of account have been kept by the Bank as required by Section 130 of the Indian Companies, Act.”

FORMS OF PUBLISHED ACCOUNTS

In order to enable the reader to acquire a thorough practical insight into the form in which Bank Accounts are presented to the public, there have been inserted at the end of this work Published Accounts of some Banks, which would prove considerably useful.

AUDITS OF INSURANCE COMPANIES

IMPORTANT PROVISIONS OF THE INSURANCE ACT, 1938

The stringent requirements of the Insurance Act, 1938, affecting the promotion, management and accounts of Insurance Business in British India and the New Forms of Revenue Accounts and Balance Sheets prescribed under the Act would need to be closely studied by the auditor.

Amongst the several IMPORTANT PROVISIONS in the New Act, the following need to be carefully noted:—

(1) Compulsory registration of every company carrying on Insurance Business in British India and obtaining of a Certificate of Registration from the Superintendent of Insurance (Section 3).

(2) Requirement of a minimum working capital of at least Rs. 50,000 exclusive of the Deposit to be made on registration and preliminary expenses, for companies carrying on Life Assurance business (Section 6).

(3) Deposits to be lodged with the Reserve Bank of India not only by Life Assurance Companies, but also by companies carrying on Fire, Marine, Accident, Workmen's Compensation, Motor Car and any other Insurance business in India, as under:—

				Rs.
(a) For Life Business only	...	...	...	2,00,000
(b) For Fire Business only	...	...	...	1,50,000

	Rs.
(c) For Marine Business only	1,50,000
(d) For Accident Business including Workmen's Compensation and Motor Car Insurance	1,50,000
(e) For Life and any one of (b), (c) or (d)	3,00,000
(f) For Life and any two of (b), (c) or (d) ...	4,00,000
(g) For Life and (b), (c) and (d)	4,50,000
(h) For any two of (b), (c) or (d) without Life Business	2,50,000
(i) For (b), (c) and (d) without Life Business ...	3,50,000
(j) For Marine Insurance relating to Country Craft ...	10,000

The above deposits have to be paid in certain stated instalments (Section 7).

(4) Separate accounts to be maintained for each class of Insurance Business, and the Life Insurance Fund to be kept intact absolutely as security for Life Policyholders (Section 10).

(5) Preparation of Revenue Accounts and Balance Sheets in respect of the different classes of Insurance Business at the end of each calendar year, in accordance with the New Regulations and Forms as prescribed in the First, Second and Third Schedules to the Act (Section 11).

(6) Audit of Annual Accounts by qualified Auditors (Section 12).

(7) The Certificates to be given by the Directors, the Actuary and the Auditors of the Company at the foot of every Balance Sheet issued by the Company, the forms of which are embodied in the Regulations given in the First Schedule to the Act.

(8) Actuarial Valuation to be made of the Life Business once at least in every five years, and the Actuary's Report and Statements to be submitted in accordance with the Regulations and Forms as prescribed in the Fourth and Fifth Schedules to the Act (Section 13).

(9) Compulsory maintenance of separate Register of Policyholders and Register of Claims in respect of every class of Insurance business (Section 14).

(10) Filing of four copies of Audited Accounts and Statements with the Superintendent of Insurance within six months from the end of the financial period (Section 15).

(11) Filing a copy of the Annual Audited Accounts with the Registrar of Companies (Section 17).

(12) Furnishing the Superintendent of Insurance with a certified copy of every Report on the affairs of the Company soon after its submission to the members or policyholders of the Company (Section 18).

(13) Filing of an Abstract of the Proceedings of every General Meeting of Shareholders within 30 days from the holding of such meeting (Section 19).

(14) Compulsory investment of Assets to the extent of 55 per cent of the liabilities in respect of Life Insurance business in Government and other approved securities (Section 27).

(15) Submission by every Life Assurance Company of a certified statement, within 31 days from the beginning of each year, to the Superintendent of Insurance showing how the above 55 per cent of the Investment has been made (Section 28).

(16) Prohibition of any Loan or temporary advance either on hypothecation of property or on personal security to any Director, Manager, Managing Agent, Actuary, Auditor or Officer of the Company except by way of loans on life policies within their surrender value, any such existing loan to be repaid within one year from the commencement of the Act (Section 29).

(17) The holding of all assets and investments in the name of the Company, except in so far as they are required to be vested in trustees (Section 31).

(18) Prohibition of appointment of Managing Agents after the commencement of this Act; existing Managing Agency to cease within three years and no existing Managing Agent to receive more than Rs. 2,000 a month by way of salary, commission and allowances put together (Section 32).

(19) Power of Superintendent of Insurance to investigate the affairs of a Company under certain circumstances (Section 33).

(20) Employment of only licensed agents in future for procuring insurance business and the remuneration to be paid to them by way of commission not to exceed the following percentages:—

40 per cent on First Year's Premium in Life Business,

5 per cent on Renewals,

15 per cent on Premium from any other business.

In case of new Life Assurance Companies:—

55 per cent on First Year's Premium, and

6 per cent on Renewals during the first ten years of business (Section 40).

(21) Prohibition of any rebate on premium being allowed in future by any canvassing agent to the insured (Section 41).

(22) Compulsory maintenance by every Insurance Company of a Register of Licensed Insurance Agents employed by them giving full details as to their names, addresses, and the dates when appointed and when the appointment ceased (Section 43).

(23) Compulsory election on the Board of every Life Assurance Company of not less than one-fourth of the whole number of Directors from the policyholders, after one year from the commencement of this Act (Section 48).

- (24) Restriction on declaration of any dividend to shareholders or any bonus to policyholders by a Life Insurance Company, except out of a surplus ascertained as a result of actuarial valuation (Section 49).

The Act also contains several new and important provisions relating to Provident Societies.

PERIODICAL ACCOUNTS OF INSURANCE COMPANIES

The New Forms of Revenue Accounts and Balance Sheets as prescribed under the Act and given herein would need to be closely studied by the auditor.

FORM A relates to the Balance Sheet of the Business. Where a Company carries on other classes of insurance business along with Life Assurance, it must prepare a separate Balance Sheet of the Life Business. So far as other insurance businesses are concerned, their respective assets and liabilities may be embodied in the General Balance Sheet with columns on either side for each class of business or a separate Balance Sheet for each class of business may be prepared. Where, however, separate Balance Sheets are prepared, the total Assets and Liabilities of each class of business must be incorporated in the General Balance Sheet in order to reflect the financial condition of the business as a whole.

FORM D is for the Revenue Account of the Life Assurance Business, wherein separate details have to be shown of Business within India and Business out of India.

FORM E is for the Revenue Account of Marine Insurance Business.

FORM F is the Revenue Account applicable to Fire, Accident, Workmen's Compensation, Motor Car and other miscellaneous Insurance business.

FORM B is the Profit and Loss Account, wherein the profit or loss of the several departments would be aggregated. To this account would also be credited items like Interest, Dividends and Rents, Profits on Sale of Investments, Transfer Fees and such other items of gain as do not belong to and are not credited to any particular Revenue Account. Similarly, the account would be charged with such expenses of management as are not applicable to any particular class of business, Loss on Sale of Investments or Depreciation of Investments which do not belong to any particular Fund and, therefore, not already charged to the Revenue Account of any class of business.

FORM C is the Profit and Loss Appropriation Account. The balance of the Profit and Loss Account would be transferred to this account. It would then be charged with any appropriations of Profit such as Dividends to shareholders, transfers to any Funds or Accounts, and its ultimate balance will appear in the General Balance Sheet.

FORM AA represents the classified summary of Investments and assets of Life Business in India, showing against each item its book value and the

market value, to be submitted within 31 days from the beginning of each year to the Superintendent of Insurance, by every company carrying on Life Insurance business.

The REGULATIONS for the preparation of the above Revenue Accounts and the Balance Sheets which are given along with the Forms need to be carefully followed, as they embody instructions for the proper compilation of these statements.

REGULATIONS FOR THE PREPARATION OF BALANCE SHEET

The First Schedule

1. The Balance Sheet required to be prepared in respect of every class of business carried on by insurer is, in the form in which it is set out in Part II of this Schedule (Form A), appropriate to a case where the insurer maintains a separate fund in respect of life insurance business.

2. The Balance Sheet of life insurance business shall be prepared as a separate document. The Balance Sheet of any class of business may be prepared as a separate document instead of being incorporated by the addition of columns and headings in the general Balance Sheet, but the total of each such separate Balance Sheet (showing the total assets of the class of business, the balance at the credit of the life insurance fund or other separate fund or account, the amount of shareholders' undivided profits, and outstanding liabilities) must in any case be incorporated in the general Balance Sheet.

3. If any combined Balance Sheet is for any purpose issued by an insurer, it shall be in accordance with the Form set out in this Schedule, and there shall not be included among the assets shown in any such combined Balance Sheet any amount in respect of any holding in or advance to any insurer whose assets and liabilities have been incorporated therein. Every combined Balance Sheet must show clearly on the face thereof that it is a combined Balance Sheet and must set out fully the name of every insurer whose assets and liabilities have been incorporated therein; if the assets and liabilities of any person not being an insurer are included in a combined Balance Sheet, the fact must be stated thereon.

4. Where any guarantee has been given by an insurer (otherwise than in the ordinary course of re-insurance business) in respect of the policies of any other insurer, the Balance Sheet of the insurer by whom the guarantee was given must show clearly the name of every insurer whose policies have been so guaranteed and the extent of the guarantee:

Provided that this regulation shall not apply where a combined Balance Sheet is issued incorporating the assets and liabilities of the insurer whose policies are guaranteed.

5. Where any part of the assets of an insurer is deposited in any place outside British India as security for the owners of policies issued in that

[Continued on page 321]

FORM
Form of

BALANCE SHEET

	Life and Annuity Business (1)	Other Classes of Business (2) ^a	Total
	Rs. a. p.	Rs. a. p.	Rs. a. p.
SHAREHOLDERS' CAPITAL (each class to be stated separately)			
Authorised :			
.....Shares of Rs.....each Rs.			
Subscribed :			
.....Shares of Rs.....each Rs.			
Called up :			
.....Shares of Rs.....each Rs.			
Less Unpaid calls			
RESERVE OR CONTINGENCY ACCOUNTS (a) :			
Investment Reserve Account			
Profit and Loss Appropriation Account Balance ..			
BALANCES OF FUNDS AND ACCOUNTS :			
Life Insurance Fund			
Fire Insurance Business Account			
Marine Insurance Business Account			
Accident and Miscellaneous Insurance Business Account (m)			
Other Accounts (if any), to be specified (l)			
Pension or Superannuation Accounts (b)			
DEBENTURE STOCK—per cent			
LOANS AND ADVANCES (c)			
BILLS PAYABLE (c)			
ESTIMATED LIABILITY IN RESPECT OF OUTSTANDING CLAIMS, WHETHER DUE OR INTIMATED (d) ..			
ANNUITIES DUE AND UNPAID (d)			
OUTSTANDING DIVIDENDS			
AMOUNTS DUE TO OTHER PERSONS OR BODIES CARRYING ON INSURANCE BUSINESS (c) ..			
SUNDRY CREDITORS (INCLUDING OUTSTANDING AND ACCRUING EXPENSES AND TAXES) (c) ..			
OTHER SUMS OWING BY THE INSURER (PARTICULARS TO BE GIVEN) (c)			
CONTINGENT LIABILITIES (TO BE SPECIFIED) (e)			
Carried over Rs.			

AUDITS OF BANKS AND INSURANCE COMPANIES

A. (The First Schedule).

Balance Sheet.

..... of 194 .

	Life and Annuity Business (1)	Other Classes of Business (2)*	Total
	Ra. a. p.	Ra. a. p.	Ra. a. p.
LOANS:			
On Mortgages of property within British India ..			
On Mortgages of property outside British India ..			
On Security of municipal and other public rates ..			
On Stocks and Shares ..			
On Insurers' policies within their surrender value ..			
On Personal Security ..			
To Subsidiary Companies (other than Reversion- ary (f)) ..			
Reversions and Life Interests purchased ..			
Loans on Reversions and Life Interests ..			
Debentures and Debenture Stocks of Subsidiary Reversionary Companies (f) ..			
Ordinary Stocks and Shares of Subsidiary Rever- sionary Companies (f) ..			
Loans to Subsidiary Reversionary Companies (f) ..			
INVESTMENTS:			
Deposit with the Reserve Bank of India (Securities to be specified) ..			
Indian Government Securities ..			
Provincial Government Securities ..			
British, British Colonial and British Dominion Govern- ment Securities ..			
Foreign Government Securities ..			
Indian Municipal Securities ..			
British and Colonial Securities ..			
Foreign Securities ..			
Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by the Indian Government or a Provincial Government ..			
Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by the British or any Colonial Government ..			
Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by any Foreign Government ..			
Debentures of any railway in India ..			
Debentures of any railway out of India ..			
Preference or guaranteed Shares of any railway in India ..			
Preference or guaranteed Shares of any railway out of India ..			
Railway Ordinary Stocks (a) in India (b) out of India ..			
Other Debentures and Debenture Stocks of Companies incorporated (a) in India (b) out of India ..			
Other guaranteed and Preference Stocks and Shares of Companies incorporated (a) in India (b) out of India ..			
Other Ordinary Stocks and Shares of Companies incor- porated (a) in India (b) out of India ..			
Carried over Rs.			

A.—Contd.

	Life and Annuity Business (1)	Other Classes of Business (2)*	Total
	Rs. a. p.	Rs. a. p.	Rs. a. p.
<i>Brought over</i>			
Holdings in Subsidiary Companies (f)			
House Property (a) in India (b) out of India			
Freehold and Leasehold ground rents and rent charges			
AGENTS' BALANCES			
OUTSTANDING PREMIUMS (g) (d)			
INTEREST, DIVIDENDS AND RENTS OUTSTANDING (d)			
INTEREST, DIVIDENDS AND RENTS ACCRUING BUT NOT DUE (d)			
AMOUNTS DUE FROM OTHER PERSONS OR BODIES CARRYING ON INSURANCE BUSINESS (h)			
SUNDRY DEBTORS (i)			
BILLS RECEIVABLE			
CASH:			
At Bankers on Deposit Account			
At Bankers on Current Account and in hand			
At Call and Short Notice (j)			
Other Accounts (to be specified) (k)			
Rs.			

number and description of each class of shares held, the amounts paid up thereon and the value at which the holdings in each company stand in the Balance Sheet.

(g) Either this item must be shown net or the commission must be provided for amongst the liabilities on the other side of the Balance Sheet.

(h) The aggregate amount owing by a subsidiary company or subsidiary companies is to be shown separately from all other assets, and the aggregate amount owing to a subsidiary company or subsidiary companies is to be shown separately from all other liabilities.

(i) Amounts due from directors and officers must be shown separately.

(j) No amount must be entered under this heading unless fully secured. If not fully secured the amounts must be included under the heading "Sundry Debtors."

(k) Under this heading must be included such items as the following, which must be shown under separate headings suitably described: office furniture, goodwill, preliminary, formation and organisation expenses, development expenditure account, discount on debentures issued, other expenditure carried forward to be written off in future years, balance being loss on Profit and Loss Appropriation Account, etc. The amounts included in the Balance Sheet must not be in excess of cost.

(l) Under the head "Other Accounts (if any) to be specified" on the left hand side, fines realized from the staff and their contribution towards the provident fund, if any, should be shown under separate sub-heads.

(m) Where the insurer is required to maintain a separate account in respect of any sub-class of miscellaneous insurance business, this heading is to be split up accordingly.

FORM*Form of Revenue Account applicable***REVENUE ACCOUNT OF
IN RESPECT OF LIFE**

	Business within India	Business out of India (a)	Total
	Rs. a. p.	Rs. a. p.	Rs. a. p.
Claims under Policies (including provision for Claims due or intimated), <i>less</i> Re-insurances :			
By Death			
By Maturity			
Annuities, <i>less</i> Re-insurances			
Surrenders, (including Surrenders of Bonus), <i>less</i> Re-insurances			
Bonuses in cash, <i>less</i> Re-insurances			
Bonuses in Reduction of Premiums, <i>less</i> Re-insurances			
Expenses of Management (b) :			
1. (a) Commission to Insurance Agents (<i>less</i> that on Re-insurances)			
(b) Allowances and Commission (other than commission included in sub-section (a) preceding)			
2. Salaries, etc., (other than to agents and those contained in item No. 1)			
3. Travelling expenses			
4. Directors' fees			
5. Auditors' fees			
6. Medical fees			
7. Law charges			
8. Advertisements			
9. Printing and Stationery			
10. Other expenses of management (accounts to be specified)			
11. Other payments (accounts to be specified)			
12. Rents for offices belonging to and occupied by the insurer			
13. Rents of other offices occupied by the insurer			
Bad Debts			
United Kingdom, British Indian, Dominion and Foreign Taxes			
Other Expenditure (to be specified)			
Profit transferred to Profit and Loss Account			
Balance of Fund at the end of the year as shown in the Balance Sheet			
	Rs.		

NOTES

(a) These columns apply only to business the premiums in respect of which are payable outside India.

(b) If any sum has been deducted from this item and entered on the assets side of the Balance Sheet, the amount so deducted must be shown separately. Under this item, the salary paid to the managing agent or managing director shall be shown separately from the total amount paid as salaries to the remaining staff.

(c) All single premiums of annuities whether immediate or deferred, must be included under this heading.

(d) British Indian, United Kingdom, Foreign and Dominion income-tax on Interest, Dividends and Rents must be shown under this heading *less* any rebates of

FORM E. (The Third Schedule).*Form of Revenue Account applicable to Marine Insurance Business.*

REVENUE ACCOUNT OF _____ FOR THE YEAR ENDED 194 .
 IN RESPECT OF MARINE INSURANCE BUSINESS.

	Current year	Last Preceding year	Previous year	Total		Current year	Last Preceding year	Previous year	Total
	Rs.	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.	Rs.
*Claims paid (<i>less</i> Salvages and Re-insurances) (a) (c) ...					Balance of Marine Insurance Business Account at beginning of the year... Balances				
*Commission ...					Additional Reserve (if any) ...				
*Expenses of Management (b) ...					*Premiums (<i>less</i> Returns, Re-insurances, Brokerages and Discount) (c) ...				
*Bad Debts ...					Interest, Dividends and Rents Rs.				
United Kingdom, British Indian, Dominion and Foreign Taxes ...					<i>Less</i> Income-tax thereon Rs.				
*Other Expenditure (to be specified) ...					*Other Income (to be specified) (a) ...				
Profit transferred to Profit and Loss account ...					Loss transferred to Profit and Loss Account ...				
Balance of Marine Insurance Business Account at end of year as shown in the Balance Sheet ...					Transferred from Appropriation Account ...				
Balances ...									
Additional Reserve (if any) ...									
Rs.					Rs.				

NOTES

(a) This heading must include all expenses directly incurred in settling claims.

(b) If any sum has been deducted from this item and entered on the assets side of the Balance Sheet, the amount so deducted must be shown separately.

(c) Where the account is furnished under the provisions of Section 11 of the Insurance Act, 1938, separate figures for claims paid to claimants in British India and claimants outside British India, and for premiums derived from business effected in British India and effected outside British India must be given

(d) All the amounts received by the insurer directly or indirectly whether from his head office or from any other source outside British India shall also be shown separately in the revenue account except such sums as properly appertain to the capital account.

* Where the account is furnished under the provisions of clause (b) of sub-section (2) of Section 16 of the Insurance Act, 1938, by an insurer to whom that Section applies, separate figures for business within British India and business out of British India must be given against the items marked with an asterisk. Against all other items the total amount for the business as a whole may be given.

FORM F. (The Third Schedule).

Form of Revenue Account applicable to Fire Insurance Business and to Accident and Miscellaneous Insurance Business including Workmen's Compensation and Motor Car Insurance Business.

REVENUE ACCOUNT OF _____ FOR THE YEAR ENDED 194 .
IN RESPECT OF _____ BUSINESS.

*Claims under policies <i>less</i> Re-insurances (a) (b) ; Paid during the year Rs. Total estimated liability in respect of outstanding claims at end of the year whether due or intimated Rs.	Rs.	Balance of Account at beginning of the year :	Rs.
<i>Less</i> Outstanding at end of previous year (b) Rs.		Reserve for Unexpired Risks	
		Additional Reserve (if any) Rs.	
*Commission		*Premiums, <i>less</i> Re-insu- rance (d)	
*Expenses of Management (c)		Interest, Dividends and Rents Rs.	
*Bad Debts		<i>Less</i> Income-tax thereon Rs.	
United Kingdom, Foreign and Dominion Taxes		* Other Income (to be specified) (e)	
*Other Expenditure (to be specified) Profit transferred to Profit and Loss Account		Loss transferred to Profit and Loss Account	
Balances of Account at the end of the year as shown in the Balance Sheet :		Transferred from Appropriation Account	
Reserve for Unexpired Risks, being per cent of premium income of year Rs.			
Additional Reserve (if any) Rs.			
Rs.		Rs.	

NOTES

(a) This heading must include all expenses directly incurred in settling claims.

(b) If in any year the claims actually paid and those still unpaid at the end of that year in respect of the previous year or years are in excess of the amount included in the previous year's Revenue Account as provision for outstanding claims, then the amount of such excess must be shown in the Revenue Account.

(c) If any sum has been deducted from this item and entered on the assets side of the Balance Sheet the amount so deducted must be shown separately.

(d) Where the account is furnished under the provisions of Section 11 of the Insurance Act, 1938, separate figures for claims paid to claimants in British India, and claimants outside British India, and for premiums derived from business effected in British India and effected outside British India, must be given.

(e) All the amounts received by the insurer directly or indirectly whether from his Head Office or from any other source outside British India shall also be shown separately in the Revenue Account except such sums as properly appertain to the Capital Account.

* Where the account is furnished under the provisions of clause (b) of sub-section (2) of Section 16 of the Insurance Act, 1938, by an insurer to whom that Section applies, separate figures for business within British India and business out of British India must be given against the items marked with an asterisk. Against all other items the total amount for the business as a whole may be given.

FORM AA. (The First Schedule).

CLASSIFIED SUMMARY OF THE (ASSETS IN INDIA) * OF THE.....
COMPANY ON 19 .

Class of Assets	Book value as per (a) below	Market value as per (b) below	Remarks as per (c) below
(1) Government of India Securities	Ra	Ra	Ra
(2) Indian Provincial Government Securities			
(3) Indian Municipal Port and Improvement Trust Securities including Debentures			
(4) Debentures of Indian Railways			
(5) Guaranteed and Preference Shares of Indian Railways			
(6) Annuities of Indian Railways			
(7) Ordinary Shares of Railways in India			
(8) Other Debentures of concerns in India			
(9) Other Guaranteed and Preferred Shares of concerns in India			
(10) Other Ordinary Shares of concerns in India			
(11) Loans on the Company's policies effected in India and within their surrender value			
(12) Loans on Mortgage of Property in India			
(13) Loans on Personal Security to persons domiciled and resident in India			
(14) Other Loans granted in India (particulars to be stated)			
(15) Land and House Property in India			
(16) Cash on Deposit in Banks in India			
(17) Cash in Hand and on current accounts in Banks in India			
(18) Agents' Balances and Outstanding Premiums			
(19) Interest, Dividends and Rents either outstanding or accrued but not due			
(20) Other Assets in India (to be specified)			

* These words were substituted for the words "Indian Assets" by s. 35 of the Insurance (Amendment) Act, 1939 (XI of 1939).

The Statement shall show—

(a) the value for which credit is taken in the Balance Sheet for each of the abovementioned classes of assets,

(b) the market value of such of the abovementioned classes of assets as has been ascertained from published quotations after deductions of accrued interest included in market prices in those cases where accrued interest is included elsewhere in the Balance Sheet.

(c) how the value of such of the abovementioned classes of assets as has not been ascertained from published quotations has been arrived at, and

(d) the rates of exchange at which the values of the assets other than in rupee currency have been converted into rupees.

The market values need not be shown separately where they are not less than the book values and a certificate to that effect is appended to the statement.

No amounts on account of any of the following items may be entered in the statement :—

Goodwill; Preliminary, formation, organisation or development expenses; Commission or Discount on shares or debentures issued; Commuted Commission; Expenditure carried forward to be written off in future years.

Continued from page 309]

place, the Balance Sheet shall state that part of the assets has been so deposited, and, if any such part forms part of the life fund, shall show the amount thereof and the place where it is deposited. Where any combined Balance Sheet is issued by an insurer for any purpose, the information required by this regulation shall be shown in the aggregate in respect of all the insurers whose assets and liabilities have been incorporated in the Balance Sheet.

6. There shall be appended to the Balance Sheet a statement in Form AA as set out in Part II of this Schedule showing the market value and the book value of the assets in India.

7. Every Balance Sheet shall contain the following certificates, namely:—

(a) a certificate signed by the same persons as are required by this Act to sign the Balance Sheet explaining how the values as shown in the Balance Sheet of the Investments in Stocks and Shares have been arrived at, and how the market value thereof has been ascertained for the purpose of comparison with the values so shown;

(b) a certificate signed by the same persons as are required by this Act to sign the Balance Sheet and signed also, so far as respects the value of any items shown in the Balance Sheet under the heading of "Reversions and Life Interests," by an actuary, certifying that the values of all the assets have been reviewed as at the date of the Balance Sheet, and that in their belief the assets set forth in the Balance Sheet are shown in the aggregate at amounts not exceeding their realisable or market value under the several headings "Loans," "Reversions and Life Interests," "Investments," "Agents' Balances and Outstanding Premiums," "Interest, Dividends and Rents outstanding," "Interest, Dividends and Rents accruing but not due," "Amounts due from other Persons or Bodies carrying on Insurance Business," "Sundry Debtors," "Bills Receivable," "Cash" and the several items specified under "Other Accounts":

Provided that if the persons signing the certificate are unable to certify that the assets set forth in the Balance Sheet are so shown as aforesaid, a full explanation of the basis upon which the values shown in the Balance Sheet have been assessed shall be given in the certificate;

(c) a certificate signed by the same persons as are required by this Act to sign the Balance Sheet and by the auditor certifying that no part of the assets of the life insurance fund has been directly or indirectly applied in contravention of the provisions of this Act relating to the application and investment of life insurance funds; and

(d) certificates signed by the auditor (which shall be in addition to any other certificate or report which he is required by law to give with respect to the Balance Sheet) certifying:—

- (i) that he has verified the cash balance and the securities relating to the insurer's loans, reversions and life interests, and investments;
- (ii) to what extent, if any, he has verified the investments and transactions relating to any trusts undertaken by the insurer as trustee; and
- (iii) in the case of a combined Balance Sheet, that he has audited the Balance Sheet and accounts of every insurer whose assets and liabilities are incorporated therein, or that any such balance sheet and accounts which have not been audited by him have been certified by independent auditors. The said certificates shall contain a reference to such reservations, if any, as may have been made by any auditor upon any report or certificate given by him with respect to the Balance Sheet and accounts of an insurer whose assets and liabilities are incorporated in the combined Balance Sheet.

8. If the values shown in the Balance Sheet in respect of "Holdings in Subsidiary Companies" or "House Property (a) in India, (b) out of India" have been increased since the last previous Balance Sheet, the certificate required by paragraph (b) of the last foregoing regulation shall state the amount of every increase not solely due to the cost of subsequent additions or, as respects holding in controlled companies, to increased profits, and shall contain an explanation of the reason therefor.

9. For the purposes of this Schedule, the following expressions have the meanings hereby respectively assigned to them, namely:—

(a) "combined Balance Sheet" includes any combined statement made by an insurer of assets and liabilities in the form of a Balance Sheet which includes the assets and liabilities of any other insurer; and

(b) "market value" means as respects any asset the market value thereof as ascertained from published market quotations, or, if there be no such value, its fair value as between a willing buyer and a willing seller.

REGULATIONS FOR THE PREPARATION OF REVENUE ACCOUNT

The Third Schedule

1. Form D is, as set out in Part II of this Schedule, appropriate for life insurance business, but a separate revenue account must be prepared for every class of business in respect of which the insurer is required to maintain a separate account.

2. Form F is, as set out in Part II of this Schedule, appropriate for fire insurance business. A separate Revenue Account in the same form must be prepared for accident and miscellaneous insurance including workmen's compensation and motor car insurance. Form E is, as set out in Part II of this Schedule, appropriate for marine insurance business.

3. If any combined revenue account is for any purpose issued by an insurer, it must be in accordance with the forms specified in this Schedule and must clearly show on the face thereof that it is a combined revenue account, and must set out fully the name of every insurer required to make separate returns under this Act whose revenue and expenditure have been included therein; if the revenue and expenditure of any person not being an insurer are included in a combined revenue account, the fact must be stated thereon.

4. The items on the income side of the revenue account must relate to income whether actually received or not, and the items on the expenditure side must relate to expenditure whether actually paid or not.

5. Re-insurance premiums, whether on business ceded or accepted, are to be brought into account gross (i.e., before deducting commission) under the head of premiums.

6. As respects life insurance business, the following statements shall be furnished to the Superintendent every year showing details provided for in a Form pertaining thereto:—

(a) A statement in Form DD as set forth in Part 2 of this Schedule.

(b) A statement in Form DDD as set forth in Part 2 of this Schedule.

(c) A statement in Form DDDD as set forth in Part 2 of this Schedule.

7. The following information shall be supplied in addition to the revenue account, namely, the Gross premium written in India for life, fire, marine and accident and miscellaneous insurance business.

8. Any office premises which form part of the assets of a life insurance fund must be treated as an interest earning investment, and accordingly, in the Revenue Account for life insurance business a fair rent for the premises must be included under the heading "Interest, Dividends and Rents" and in the Revenue Account for every class of business for which the premises are used, proper charges for the use thereof must be included under the heading "Expenses of Management".

9. When an insurer carries on business of Life Insurance in conjunction with any other class of insurance business, the expenses of management charged to the life insurance Revenue Account must not include more than a reasonable proportion of the common expenses and in particular, no such account must be charged with more than a fair sum for the use of any office premises having regard to the income from the various classes of business carried on and to the extent to which premises are used for the purposes of each class of business.

10. Deductions from Interest, Dividends and Rents in respect of income-tax must include all income-tax charged on such income whether or not it has been or is to be deducted at source or paid direct; the income-tax to be shown as so deducted in the Life Insurance Revenue Account is British Indian, United Kingdom, Foreign and Dominion Income-tax, but the Income-tax to be shown as deducted in Revenue Accounts of any other classes of business is British Indian Income-tax only.

REGULATIONS FOR THE PREPARATION OF PROFIT AND LOSS ACCOUNT

The Second Schedule

1. The items on the income side of the Profit and Loss Account and Profit and Loss Appropriation Account must relate to income, whether actually received or not, and the items on the expenditure side must relate to expenditure whether actually paid or not.
2. Deductions from Interest, Dividends and Rents to be shown in respect of Income-tax must include all amounts in respect of British Indian Income-tax whether or not it has been or is to be deducted at source or paid direct.
3. The Interest, Dividends and Rents less income-tax thereon shown in the Revenue Accounts for any classes of business other than life insurance business, including annuity business may, if the insurer so desires, be included with the corresponding items to the Profit and Loss Account.

BALANCE SHEET OF LIFE BUSINESS

The Balance Sheet of Life Insurance Business must be prepared as a separate statement, in the prescribed Form marked 'A.' The Balance Sheet of other classes of business may be prepared separately, or their assets and liabilities may be incorporated by means of additional columns in the General Balance Sheet. In any case, where there are several classes of business, a General Balance Sheet will have to be prepared incorporating the total fund of each class of business as also the shareholders' undivided profits, outstanding liabilities and such other items of a general nature, so as to indicate the financial position of the business as a whole.

The following items need specific mention:—

LIFE ASSURANCE FUND

Having regard to the peculiar nature of the Life Business, the excess of revenue over expenditure of any particular year, as shown by its Revenue Account, cannot be said to be the profits made in that period. A mistake is sometimes made of supposing that the accumulated funds of a life insurance company are profits made out of the business and held undivided. This, however, is not the case. If the company ceased to accept new policyholders and simply allowed the existing contracts to work off by death or maturity, the funds would gradually be drawn upon for the purpose of paying claims, which the annual income received by way of renewal premium alone during the time would be unable to meet. The difference represented by the excess of income over expenditure is called Life Fund and is carried forward on this account from year to year. The profits of any period are ascertained by an

Actuarial Valuation every three or five years. The object of such a valuation is to arrive at the net liability of the company under the various policies as at the date of valuation, and this amount the company must have in hand if it is solvent. The net liability of the Company on all its policies in force, thus ascertained, is compared with the then Life Assurance Fund, and the excess of the latter over the former is called "surplus" and is available for dividend, whilst the balance the other way is called the "deficiency".

ANNUITY FUND

This item represents the liability of the company to its annuitants, which is ascertained by periodical actuarial valuation. Usually, Annuity Business is mixed with the Life Assurance Business, in which case, there is no separate Annuity Fund but the same is merged into the Life Assurance Fund.

LOANS ON LIFE INTERESTS AND REVERSIONS

These are loans granted to persons having either a life interest in certain properties or assets, or to those in whom the legal right to such property reverts upon the death of the life tenant.

INVESTMENTS

These will have to be shown under their specific heads as indicated in the Prescribed Form of Balance Sheet. The requirements of Section 27 in regard to 55% of the company's liability to its policyholders being held in approved Securities should be rigidly followed.

SUBSIDIARY COMPANIES

Particulars of holdings in and loans to and from subsidiary companies are required to be shown quite distinctly from other assets and liabilities.

DEBTS OWING BY DIRECTORS AND OFFICERS

Amounts due from directors and officers are required to be shown separately.

GUARANTEE IN RESPECT OF POLICIES IN OTHER COMPANIES

Where any guarantee has been given by a Company in respect of policies of any other company, the Balance Sheet of the Company giving such guarantee must clearly specify the name of such company and the extent of such guarantee:

SUNDRY OTHER ASSETS

Assets such as Goodwill, Office Furniture as also the balance on accounts like Preliminary Expenses, Organization and Development Expenses, Discount on Issue of Debentures and such other items are required to be shown last on the assets' side, until written off.

CONTINGENT LIABILITIES

Under 'Contingent Liabilities' will have to be included liabilities in respect of Bills Discounted, partly-called shares held in subsidiaries and in other companies as investments and liabilities under any actions pending.

All other requirements as to the preparation and certification of Balance Sheets are specified in the REGULATIONS contained in the FIRST SCHEDULE to the Act as also in the NOTES embodied at the foot of the prescribed FORM A of Balance Sheet, and these have been included bodily herein, so as to facilitate reference.

SPECIAL FEATURES IN AN INSURANCE COMPANY AUDIT

Here also, a detailed audit of the whole of the transactions by the auditor is out of question, and the auditor has perforce to rely to a great extent on the system of internal check in use in the concern. The auditor will have, therefore, to very carefully scrutinise the system of internal check obtaining in the concern to ascertain how far the system can be relied upon, before he proceeds with his work.

The following are the special features of an Insurance Company Audit:—

- (1) Vouch the Premium Income with counterfoil receipt books.
- (2) Vouch the Commission paid and payable to the Agents and Canvassers with their accounts. See that such Commission is calculated according to the terms of agreements with the Agents. See that all Outstanding Commission due and not paid is brought into account.
- (3) See that in no case does the rate of commission exceed the scheduled rate under the Act.
- (4) Verify the Claims Paid from the Cash Book into the Claims Register, vouch the same with the Cancelled Policies and the Directors' Minutes sanctioning the same.
- (5) See that all Claims Admitted and not paid are brought into account, and that the amount agrees with the total of the schedule of Outstanding Claims as got out from the Claims Register. Claims intimated and not admitted will also have to be provided for.
- (6) Check payments in respect of Surrenders with Endorsements on the Cancelled Policies, and with acknowledgments from the payees.
- (7) Vouch all payments and recoveries in respect of Re-insurances, and see that the Outstanding Liability or asset on this head is provided for.
- (8) Verify the Investments, ascertain the basis of valuation, and see that if the total market value of these is less than the book value, the difference is provided for: Further, see that all interest received from Investments is duly brought into account, and interest accrued and not received is taken credit for.

(9) See that the Loans on the Company's Policies are within their Surrender Values.

(10) See that in no case the Loan on Policy and Interest thereon exceed the surrender value of the policy. Where the Loan and Interest exceed the surrender value, see that the loan is not allowed to stand as such, but the policy is written off as surrendered and lapsed.

(11) Check all Annuities paid, and see that all Annuities due and unpaid are provided for.

(12) See that Outstanding Premium is brought in at its correct figure, and the liability in respect of the commission due on this is also duly provided for.

(13) See that there is a proper apportionment of management expenses over the several departments.

(14) Carefully scrutinize the outstanding branch and agency balances to ascertain that they are all recoverable.

(15) Examine the actuary's certificate of actuarial valuation to verify any entry passed in respect of surplus ascertained on Life Fund.

(16) See that the final accounts are prepared in the form prescribed by the Insurance Act. Separate Revenue Accounts should be prepared for each class of Insurance transacted, and the assets and liabilities of the Life Business should be shown in a separate Balance Sheet.

(17) In case of Insurance Business other than Life, see that the provision for unexpired risks is duly made by a certain proportion of the premium income being carried forward.

A complete audit of Insurance Companies must necessarily call for not only a thorough scrutiny of the account books and vouchers by the Auditor as already mentioned above, but also a close examination into the facts that all the varied requirements of the New Act as to the maintenance of Statutory Registers, the separate record of Life Transactions, the proper Investment of the Life Fund, the Deposits to be lodged with the Reserve Bank, the preparation of periodical accounts on prescribed forms, the restriction on declaration of Dividend and all matters affecting accounts have been duly carried out.

AUDITOR'S REPORT AND CERTIFICATE

The form of the Auditor's Report and Certificate to be given at the foot of the Balance Sheet of an Insurance Company is governed by the New Regulation No. 7(c) and (d) embodied in the First Schedule to the Insurance Act, 1938. As a result of these requirements, the Auditor's Report to the shareholders will ordinarily take the following shape:—

“We have audited the annexed Balance Sheet of the.....
Company, Limited, as at.....19..., and the Revenue Accounts,
the Profit and Loss Account and the Profit and Loss Appropriation
Account of the company for the year ended upon that date in which

are incorporated the Returns from the various Branches and Agencies, and we beg to report that:—

(a) We have obtained all the information and explanations which we have required.

(b) In our opinion, the annexed Balance Sheet, Revenue Accounts, Profit and Loss Account and Profit and Loss Appropriation Account are drawn up in conformity with the law.

(c) Such Balance Sheet exhibits a true and correct view of the state of the company's affairs according to the best of our information and the explanations given to us and as shown by the books of the company.

(d) In our opinion, the books of account have been kept by the company for the year under report as required by section 130 of the Indian Companies Act.

(e) We have verified the cash balances and investments by actual inspection or by the production of certificates or vouchers, and have also verified the securities relating to the Loans.

(f) No part of the assets of the Life Assurance Fund have been directly or indirectly applied in contravention of the Insurance Act, 1938, relating to the application and investment of Life Assurance Funds."

Auditors.

The Certificate required to be given by the Directors at the foot of the Balance Sheet will ordinarily be worded as under:—

"We certify that—

(1) The investments have been valued in the Balance Sheet at or below cost. The book values of the investments are in the aggregate below their market prices as at the date of the Balance Sheet. The market prices of all the investments have been ascertained as per the market quotations given by brokers or bankers, excluding therefrom the accrued interest where it is included in such quotations.

(2) The values of all the assets have been reviewed as at the date of the Balance Sheet, and that in our belief, the assets set forth in the Balance Sheet are shown in the aggregate at amounts not exceeding their realisable or market value under the several headings:—'Loans', 'Investments', 'Agents' Balances', 'Outstanding Premiums', 'Interest, Dividends and Rents outstanding', 'Interest, Dividends and Rents accruing but not due', 'Sundry Debtors', 'Cash', 'Furniture and Fittings', etc.

(3) No part of the assets of the Life Assurance Fund has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938, relating to the application and investment of Life Assurance Funds."

Directors.

SPECIMEN PUBLISHED ACCOUNTS

As the Auditors' Report and the Directors' Certificate are required to be very carefully worded, and as such report or certificate will have to be varied as circumstances may demand, it has been thought necessary to embody at the end of this work, published accounts of several Indian Insurance Companies. A critical study of these accounts will, no doubt, be of invaluable help to students in order to enable them to acquire a complete and comprehensive idea of how the various items should be stated in the Revenue Accounts and the Balance Sheets of Insurance Companies, and also as to how the Auditors' Report and the Directors' Certificate should be worded.

FIRE INSURANCE AUDIT

The following special points in the audit of Fire Insurance Companies need to be carefully noted:—

(1) The auditor should first make a close study of the system of Account-keeping and Internal Check in force, particularly in regard to the record of Premium Income, incorporation of Agents' periodical statements, and the claims made on the Company and their subsequent payment.

(2) As Premiums form the chief source of income, detailed checking must be made of the entries in respect thereof from the counterfoil receipt books into the Premium Cash Book. The Agents' Statements should also be checked to ensure that premiums collected by them have all been duly brought in.

(3) All Investments and Securities must be verified by personal examination of scrips or with the Bankers' Certificates.

(4) Interest and Dividends from Investments must be thoroughly scrutinised to see that all such income has been duly received, and that Interest and Dividends outstanding and accrued have been properly brought in.

(5) The record of all collections and disbursements by the Agents must be verified with their monthly statements.

(6) Particular scrutiny will have to be made of the losses and claims paid and outstanding, and it should be seen that all claims are paid after being sanctioned by the Board.

(7) The Claims Register must record full details of each claim made, when it was accepted by the Board and when finally paid.

(8) All Outstanding Claims must be checked from the Claims Register into the list of Outstanding Claims.

(9) In order to ensure that there are no irregularities in the accounting for premiums, it is highly desirable that Insurance Policies on which claims have been paid should be traced into the Premium Cash Book to ascertain that the Company actually received the Premiums on the risks in respect of which payments were made to the insured.

(10) Commission paid to Agents must be vouched with their receipt and also their accounts.

(11) It should be seen that all commission outstanding is brought into account.

(12) See that no commission is paid on business secured by the Head Office without the intervention of an Insurance Agent.

(13) It should be seen that the Rates of Commission allowed to Licensed Insurance Agents do not exceed the maximum percentage allowed under the Insurance Act.

(14) All Re-insurance losses paid should be properly verified with their relative documents.

(15) It should be seen that a proper Reserve is provided for Re-insurance Losses due and outstanding.

(16) There should be a proper system of recording Re-insurances so that the record may clearly indicate the collection of the *pro rata* part of the losses payable by other companies, and how much of such recoveries remain outstanding at the close of the fiscal period.

(17) Balances due from the Agents at the close of the financial period as shown by the Ledger Accounts must be thoroughly verified by comparison with the closing balances as shown by the Agents' last monthly statements.

(18) All establishment expenses and other out-goings must be carefully vouched to see that they are duly authorised.

(19) All claims or losses in dispute, if not provided for, should be shown as Contingent Liabilities.

(20) It should be seen that all liabilities in respect of accrued and unpaid expenses are duly brought in.

(21) Agents' Balances of long standing should be scrutinised particularly to ascertain how far they are recoverable, and that proper provision is made for doubtful debts.

(22) A few of the accounts in the Agents' Ledger should be checked with the monthly returns from the Agents to ascertain that these are duly incorporated.

(23) If any claims are cancelled as rejected, the same should be verified with Board's minute.

(24) See that all Treaties and Agreements are duly ratified by the Board.

(25) See the Board's sanction regarding investment of the company's surplus Funds.

(26) Where part of the Company's Funds are held by another company under any Treaty, a certificate in respect of the Funds held by them should be obtained from the company concerned.

(27) See to proper provision being made in respect of Unexpired Risks.

CHAPTER XIII

SPECIAL POINTS IN DIFFERENT CLASSES OF AUDITS

It is now proposed to enumerate in this Chapter the special points which arise in the various classes of audits. While so considering the principal features of each audit, matters appertaining to detailed routine checking, which are common to all audits and which have already been considered exhaustively in the previous pages, are omitted in order to avoid repetition.

RAILWAY COMPANIES

Railway Companies have their own Internal Audit Departments for the purposes of maintaining an efficient control on the various departments, and for carrying out an exhaustive audit, and it is not, therefore, necessary, nor would it be possible for the auditor on behalf of the shareholders, to conduct a detailed audit.

The principal duties of the auditor would be:—

(1) To acquaint himself with the system of Internal Check and Audit, and to study the Special Act of Parliament, noting particularly any provisions affecting accounts.

(2) To verify the Journal entries appertaining to traffic receipts with the monthly Traffic Summary Book, and to see that the latter is duly initialled as examined with the Returns certified by the Station Masters.

(3). To test some of the Returns of cash remitted by the Stations with the entries in the subsidiary Cash Books, and to check the transfers of the cash summaries into the General Cash Book.

(4) To check the monthly summaries in respect of passenger, goods, minerals and other receipts into the respective Ledger Accounts.

(5) To check the Railway Clearing House statements into the Clearing House Journal, and thence into the Ledger Accounts.

(6) To verify most carefully the items of Capital Expenditure with the certificates of Engineers and other responsible officials; and to see that the allocation of expenditure between Capital and Revenue is done on sound and proper basis.

(7) To test a few of the items of Revenue Expenditure with the original vouchers to ascertain that there is no irregularity in the system of Internal Check.

(8) To verify all Securities, Title Deeds, etc., and consult the company's Solicitors where necessary.

(9). To see that the Inventories of Stocks and Stores on hand are duly certified by responsible officials.

(10) To check the Outstanding Traffic Accounts with the summaries of the certified Balance Sheets from the various Stations.

(11) To check the Outstanding Liabilities from the Outstanding Liabilities Book into the Certified Returns from the Stations and other Departments.

(12) To see that the amount unearned in respect of unexpired periods of Season Tickets is duly carried forward.

(13) To see that interest on all Loans or Debentures is duly provided for and to verify the Redemption of Loans or Debentures, if any.

(14) To check the balances from the General Ledger into the Final Accounts.

(15) To compare the various items on the Revenue Account on the debit and credit with similar items of previous periods, and obtain explanations in case of any large fluctuations.

(16) To see that the Final Accounts are prepared in the Form required by Statute.

SHIPPING COMPANIES

The special features in the audit of Shipping Companies' Accounts would be:—

1. To enquire into the system of Internal Check.
2. To verify the Journal entries with the certified summaries of passage money and freight received.
3. To see that a separate Ledger is maintained for each ship and a separate Account is kept relating to each voyage.
4. To examine each Voyage Account to see that all expenses relating to each voyage are properly charged thereto, and that each such Account is duly credited with its legitimate freight and passage money.
5. To ascertain that each Voyage Account is credited with the value of Stores in hand at the end of the voyage and that the same is debited to the succeeding Voyage Account.
6. To see that all Outstanding Liabilities in respect of each Voyage Account are duly brought into account.
7. To see that the Insurance Premium attributable to each voyage is properly charged to such Voyage Account.
8. To ascertain that unearned moneys received on account of Return Passages not utilised are properly carried forward.
9. To examine the Agents' Accounts, Statements received from Insurance Brokers and Tradesmen, Statements from Average Adjusters, Statements for Repairs and Re-conditioning, etc., to see that they are duly incorporated.
10. To see that due provision is made for the remuneration and other charges of the Managing Agents.

11. To look into the question of how the Foreign Exchanges are dealt with.
12. To enquire if an Insurance Fund is maintained, and, if so, to see that the same is kept up on a proper level and that the corresponding amount is specifically invested.
13. To scrutinise all items of Capital Expenditure to see that all Repairs and Renewals are charged off to revenue. Where, however, an unusually heavy amount is expended on overhauling a vessel, the same is allowed to be spread over a reasonable number of voyages.
14. To enquire into the question of proper depreciation being written off each ship.

ELECTRIC LIGHT AND POWER COMPANIES

The special features in the audit of an Electric Light and Power Company would be as follows:—

- (1) Ascertain the system of Internal Check in use.
- (2) Note provisions affecting the accounts in the company's Special Act or in the Memorandum and Articles.
- (3) See that the allocation of Wages into Capital and Revenue is certified by the company's Engineer.
- (4) See that repairs and replacements of existing assets are charged to revenue, and only the cost of additional assets is capitalised.
- (5) Check a portion of entries in the Consumers' Tabular Ledger with the original records by way of test.
- (6) See that all allowances to consumers are duly authorised.
- (7) See that arrears on Consumers' Accounts are properly carried forward periodically, and check the final balances as appearing from the Consumers' Ledger into the schedules of Outstanding Consumers' Balances.
- (8) Check postings of periodical totals from Consumers' Ledger to the Impersonal Accounts concerned.
- (9) Inspect contracts with Local Authorities for charges in respect of public lighting.
- (10) See contracts with other consumers for current supplied for motive power.
- (11) Verify some of the items of Stores Inventories with the Stores Ledgers, and see that the Stock Sheets are properly certified.
- (12) See that the apportionment of salaries of Accountants, Engineers, Managers, Secretaries, etc., between Generation, Distribution and Management expenses is done on proper and consistent basis and that such allocation is certified by the Chief Engineer or the Managing Director.

(13) See that the Power House Building, Plant and Machinery, Mains, Meters, etc., are properly depreciated.

(14) See that the accounts are prepared in the Prescribed Form.

COLLIERIES

The auditor will have to direct his special attention to the following items:—

(1) The system of recording wages, the preparation of the wages sheets and the subsequent payments must be fully gone into.

(2) The capital expenditure incurred on pit-sinking, on driving the main shaft, on the construction of surface Railway Lines and underground Tramways and on the Workmen's Cottages and the acquisition of Plant and other fixed assets should be thoroughly scrutinised.

(3) Where waggons are purchased on the Hire Purchase System, it should be enquired whether the instalments paid have been correctly apportioned between Capital and Revenue.

(4) The annual depreciation on such waggons should not be calculated on the instalments paid but on the full cash value of the waggons.

(5) The question of "Minimum Rent, Short Working and Royalties" must be thoroughly gone into by an inspection of the necessary leases and agreements.

(6) Whether the Short Workings can be recouped out of future Royalties when the latter exceed the Minimum Rent, such Short Workings may be shown as an asset in the Balance Sheet.

(7) The question of allocation of expenditure between Capital and Revenue must be thoroughly scrutinised, and all such allocations should be certified by the Mining Engineer and the Mine Manager.

(8) The expenses incurred on the development of each section of the Mine will require close scrutiny. Ordinarily, such expenditure should be distributed over the period during which each such section is expected to be remunerative.

(9) The total quantity of output and the cost of output per ton should be compared with similar figures of the previous period.

(10) The question of depreciation of Plant and Machinery, Railway Lines, Rolling Stock, Cages and Ropes, Tubs, etc., must be thoroughly gone into.

(11) The basis of valuation of unsold stock of coal must be ascertained. Where the cost of output is more than the selling price, the stock should be valued at the net selling price.

(12) The sales must be verified with the Sales Agents' Accounts, and contracts with Railway companies and other consumers should be examined to verify the rates charged.

(13) It should be seen that all liabilities under any contracts for supplies are duly brought into account.

(14) The quantity of closing stock can be easily verified by taking the opening balance and adding thereto the quantity of coal got out during the period, and deducting from this total, the quantity of coal sold and that consumed by the Colliery. Of course, some allowance will have to be made for loss in screening, etc.

(15) The Company's Articles must be seen to ascertain whether there is any obligation to provide depreciation on its Leases and Mining Concessions, etc. Although in the absence of any such requirement under its Articles, there will be no legal necessity for the Company to provide for the loss of capital outlay of the Mine due to the exhaustion of the mineral, yet as a measure of sound finance, it would be advisable to write off the whole of such cost over the estimated period during which the Mine will be expected to yield coal.

RUBBER PLANTATIONS

The principal points in the audit of a Rubber Plantation Company would be:—

1. To ascertain the terms and conditions on which such properties are held by verification of Title Deeds and other documents.
2. To carefully scrutinise all items of Capital Expenditure. Only the expenses incurred on development and up-keep of immature areas and on extensions and new plantations should be capitalised.
3. To see that all expenses incurred by way of maintenance and cultivation of areas in bearing as also the expenses relating to the manufacture of rubber are charged off to revenue.
4. The monthly summary of the Estate Manager's transactions should be carefully examined with the Journal entries.
5. The allocation of the general and the administration charges between Capital and Revenue should be most carefully scrutinised. Such allocation is usually made in proportion to the ratio that the acreage of the areas in bearing and that of areas not in bearing bear to the total acreage of the Estate.
6. The total quantity of Rubber produced as shown by the Estate Returns should be compared with the quantity shipped and the unsold quantity on hand.
7. Enquire into the method adopted for the purpose of converting the Estate transactions into the Head Office currency, if the Estate is located in a foreign country.
8. Enquire into the basis of valuation of the Stock of Rubber on hand at the date of closing.

9. See that the advances to workmen not recoverable are duly provided for.

NEWSPAPERS, PERIODICALS AND PUBLISHERS

The special features in the audit of such a concern would be as follows:—

- (1) Vouch Subscription and Advertisement Receipts.
- (2) See that unexpired Subscriptions and Advertisements received in advance are properly carried forward.
- (3) See that there is a proper system of charging out copies sent to newsagents and the returns from them.
- (4) Amounts paid to contributors should be vouched with their acknowledgments.
- (5) Agreements with authors should be seen to ascertain the Royalties payable.
- (6) See that proper Production Account is maintained for each work produced. Stock of unsold Books should never be valued above cost, and where the publication fails to command sales, the book value should be written down considerably. The Stocks should be certified as to quantity and value. Some of these may be tested with reference to quantities, progress of sales and sale prices.
- (7) See that all outstandings in respect of Commission due to selling agents, amounts due to Contributors, and Royalties to authors are duly provided for.
- (8) See that proper provision is made in respect of any libel or other action that may be pending against the company.
- (9) Copyrights should be revalued from year to year. Copyrights of such publications as are not saleable should be written off. Under no circumstances should copyrights be allowed to be written up.
- (10) See if any expenditure on advertising the paper or periodical is capitalised, and, if so, enquire whether such expense is of an exceptional nature and whether the paper is likely to realise benefit out of this in future.
- (11) See that unsold copies of works published at author's risk are not included in stock.
- (12) Enquiry into the basis of valuation of Blocks for Illustrations and Types not in constant use.
- (13) The Depreciation of Types should be carefully scrutinised. Types in constant use would require to be depreciated as much as $33\frac{1}{3}\%$.
- (14) Printing Machinery would have to be depreciated from $7\frac{1}{2}\%$ to 15% .
- (15) See that Books or Periodicals out with Selling Agents and Booksellers on Sale or Return are not included in Sales.

(16) See that amounts realised on sale of old types, old paper and books are duly certified.

(17) See that Goodwill Account is not unnecessarily swollen by charging thereto items which should fairly go to revenue.

BUILDERS AND CONTRACTORS

The special features in connection with the Audit of such concerns would be:—

(1) The system of ordering, and the recording of the receipts and issues of stores and materials to the various contracts or jobs, and also of the stores, if any, returned from such jobs should be examined.

(2) It should be seen that there is a proper system for the ascertainment and the subsequent payment of wages.

(3) The allocation of wages to the various contracts should be certified by some responsible official.

(4) See that depreciation on any plant specifically used for any job is charged to that particular Contract Account.

(5) See that a proper record is maintained as to the transfer of plant from one contract to another.

(6) See that a separate Account is opened for each contract and that each such Account is charged with the proper amount of wages, material, stores and other direct charges attributable thereto.

(7) The basis of apportionment of the administration charges to each contract should be ascertained.

(8) The question of the valuation of Work-in-progress should be closely scrutinised.

(9) Where any profit is taken credit for on uncompleted contracts, it should be seen that the same is done on a most conservative basis after making full allowance for all likely contingencies.

(10) The agreements and building contracts must be seen to ascertain that all likely liabilities under these are duly brought into account.

(11) The amounts received on account of contracts should be verified with the Architects' Certificates, and it should be seen that the retention moneys are held back as per the agreements.

(12) The basis of valuation of the stock on hand must be ascertained and the stock sheets should be certified by some responsible officials.

(13) The Plant and Machinery used on the contracts should be freely written down.

(14) In case of a Limited Company carrying on the business of builders and contractors, see if the Articles prescribe any particular mode of valuation of Work-in-progress, etc.

(15) Where proper Cost Accounts are maintained, see how far they agree with the Financial Accounts.

THEATRES AND CINEMAS

The principal items in the Audit of Theatrical Accounts will be as follows:—

(1) Enquire into the system of check upon the daily receipts of tickets for reserved and unreserved seats, and check a portion of the counterfoils of tickets into the Daily Returns of Tickets Sold.

(2) Verify the total of Daily Returns of Tickets Sold with the entries in the Cash Book.

(3) Check a portion of Bar Receipts and see that these are daily supervised and initialled by someone in authority.

(4) All items of Capital Expenditure will have to be scrutinised.

(5) The depreciation of Wardrobe Materials, Dresses and Scenery will call for most careful scrutiny.

(6) Amount expended on Scenery for any particular production should be written off from the earnings of such production.

(7) The whole cost of each production including the expenses on repairs and replacements and wardrobe purchases and other expenses incurred in running the production should be spread over the income of such production.

(8) All liabilities in respect of Purchases of Materials, Advertising, Posters, etc., should be brought into account.

(9) Amounts received in respect of Advance Bookings should be properly carried over.

(10) The valuation of Copyrights of Productions should be most thoroughly scrutinised and it should be seen that only the Copyrights of such Plays as have proved successful and in respect of which there are prospective chances of securing good houses need be valued.

(11) The Advertisement Receipts should be checked into the Advertisement Contracts Book.

(12) In case of a Touring Company, the receipts as also the travelling and other expenses should be certified by the Touring Manager.

(13) In Cinema Business, the agreements for the Purchase, Hire and Sub-letting of Films should be inspected.

(14) The valuation of Films on hand should receive the auditor's most careful attention.

(15) The depreciation of Fixtures and Fittings relating to the sitting accommodation should receive careful consideration.

FINANCE AND TRUST COMPANIES

(1) Study carefully the Memorandum and Articles of Association of the Company to ascertain the objects of the company and the restrictions, if any, placed on the classes of Investments in which the funds of the company may be invested.

(2) Verify the Purchases and Sales of Investments with the Brokers' Bought and Sold Notes.

(3) See to the proper apportionment of Principal and Interest on the purchase and sale of Securities and of Stocks and Shares.

(4) Ascertain that all Interest or Dividend recoverable is properly accounted for, and that any Interest or Dividend outstanding is duly taken credit for.

(5) The verification of Investments and Bank Balances must receive due attention.

(6) The basis of valuation of Investments must be carefully scrutinised. It would be sound and prudent, in all cases, to write down the book value of these to market price, if the latter happens to be lower. In any case, the basis of valuation must be clearly indicated on the face of the Balance Sheet. In case of a Trust Company, where the Investments are held as fixed assets, there is no legal obligation to provide for the fall in value, unless the Company's Articles so provide.

(7) See the Directors' Minutes authorising the various financial transactions.

(8) If the company holds any partly-paid shares, see that the Contingent Liabilities in respect of Calls not yet made is disclosed in the Balance Sheet.

(9) In a Trust Company, Loss on Sale of Investments would be a Capital Loss and need not necessarily be made good from out of current profits, unless the Company's Articles require otherwise, though financially it would be sound to charge it to revenue. Similarly, Profit on Sale of Investments would be a Capital Profit and it would not be prudent to carry the same to Profit and Loss Account. Legally, however, there can be no objection to distributing such profits, if the Articles do not forbid such a distribution, and provided the profit is realised in cash and there is a surplus left after the whole of the company's assets and liabilities are re-valued.

(10) In a Finance Company, where the Investments are held with a view to re-sale and are in the nature of floating assets, any profit or loss on sale of Investments would be transferred to Profit and Loss Account.

(11) The question of Depreciation of Investments will depend on the constitution of the company. Where they are held as Fixed Assets, there is no legal necessity to bring down their book value to the market price, if the latter is lower, though financially it would always be sound to do so.

This would, of course, be subject to the company's Articles. On the other hand, where the Investments are held as Floating Assets, they must always be valued at cost or market price whichever happens to be the lower at the date of the Balance Sheet.

SOLICITORS' ACCOUNTS

The following would be the special features in the audit of a Solicitors' Accounts:—

(1) Separate Bank Accounts should be maintained in respect of Office Moneys and Clients' Moneys.

(2) The system of charging out to clients the disbursements made on their account should be scrutinised.

(3) Some of the entries in the Clients' Disbursements Cash Book should be verified with the original vouchers.

(4) A portion of the postings from the Clients' Disbursements Cash Book should be tested into the Clients' Disbursements Ledger.

(5) The Register of Bills Delivered should be examined in detail.

(6) The Clients' Ledger Balances should be scrutinised and checked into the schedules.

(7) It should be seen that Premiums received from Articled Clerks are apportioned over the period of the Articles.

(8) All Outstanding Liabilities for fees due to Counsel, etc., should be brought into account.

(9) To see that amounts received as advances against law-suits or other matters are shown as liabilities.

(10) To bring into account estimated costs on incomplete matters not charged to clients.

(11) In case of a partnership firm, the auditor should examine the Partnership Deed to ascertain the arrangement as to the division of net income.

EXECUTORS' ACCOUNTS

The Audit of Executors' or Trustees' Accounts will call for scrutiny of the following special points:—

(1) To inspect the Will of the deceased, and make notes of the legacies payable and other instructions as to the division of the Estate.

(2) To examine the schedules submitted along with the Estate Duty Affidavits to ascertain what assets and liabilities were left by the deceased and to see whether the Opening Entries in the books of the Executors duly bring in all such items.

(3) To see that all income by way of rents, interest, dividend, etc., accruing to the date of death has been properly capitalised and brought in as forming part of the Estate of the deceased as at the date of death.

(4) To see that proper amount of Estate and other Duties has been paid.

(5) To verify the existence of all assets and investments brought into account and to see that all income from each such investment is duly accounted for.

(6) To verify the purchase and sale of securities with the Brokers' Contract Notes and to see that correct apportionment is made in respect of interest accrued up to the date of purchase or sale.

(7) To vouch the purchase or sale of real property with the statements submitted by the Estate Agents or Auctioneers.

(8) To ascertain that all the debts of the deceased have been satisfied.

(9) To see that all legacies, devices, annuities, etc., have been paid in accordance with the will.

(10) Where the Estate consists of several Landed Properties, to see that a proper Rent Roll is maintained and all Rents recoverable are duly brought into account.

(11) If any portion of the Estate is left in trust, to see that the same is properly dealt with and that the Investments representing such Trust are in accordance with the dictates of the will or in other authorised securities.

(12) To see that the Residue of the Estate is dealt with as required under the Will.

HOTELS

The special features in Audits of Hotels would be:—

(1) To enquire into the system of Internal Check regarding:—

(a) The ordering, receipt and payment of Provisions, Wines, Stores, etc.

(b) The receipt of cash and the accounting thereof by the waiters, cashiers, etc.

(c) The method of charging all extras daily to the Visitors' Accounts in the Window Ledger.

(d) The quantity, record of Wines, Spirits and Provisions and other Stores.

(e) The agreement of the Window Ledger with the Total Visitors' Account in the General Ledger.

(2) Check receipts from visitors from the Cash Book into the Window Ledger.

(3) Check the periodical postings from the Window Ledger into the Impersonal Accounts.

(4) See that the total of the list of Outstanding Balances as ascertained from the Window Ledger agrees with the Balance of the Total Visitors' Account in the General Ledger.

(5) Bar and Billiard Room Receipts will have to be carefully checked.

(6) See that Purchase Invoices are properly allocated, and that no revenue charge is wrongly capitalised.

(7) Check the Bought Ledger Accounts in detail and verify the closing balances of creditors with their statements.

(8) See that the Wages and Salaries are properly certified.

(9) The Inventories of Stocks actually taken should be compared with the Stock Ledger Accounts by way of tests.

(10) Unusual outlay on painting or decorating may be spread over a period of two or three years.

(11) Scrutinise all items of Capital Expenditure.

(12) See that the depreciation of Fixtures and Fittings, Bed and Table Linen, Plate, Cutlery, Glass, China and Kitchen Utensils is provided for on a fair and consistent basis.

HOSPITALS

The special points in a Hospital Audit would be:—

(1) To check Cash Receipts from counterfoil Receipt Books into the Cash Book, and see that no Receipt is missing.

(2) To see that all income that should have been received by way of Rents from Properties, and Dividends and Interest from Investments is duly accounted for.

(3) To see that the Bank Account is properly reconciled and a certificate is obtained from the Bankers.

(4) To trace all the Subscriptions and Donations as acknowledged in Newspapers into the Cash Book.

(5) To ascertain that Legacies and Donations given for a specific fund are applied towards the same purpose.

(6) To see that all Purchases are duly authorised.

(7) To see that the Grants, if any, received from Local Authorities are duly accounted for.

(8) To verify the Trust Deed and see that the Securities and the Title Deeds are held in the joint names of the Trustees.

CLUBS

- (1) Examine the rules and regulations of the club, and make notes of those affecting accounts.
- (2) Vouch receipts from Entrance Fees and Subscriptions from members with counterfoil receipt books, and see that these are dealt with as required under the rules.
- (3) Agree the total Subscriptions received as shown by the Financial Ledger with those as ascertained from the Subscription Register.
- (4) See that a list of Subscriptions in Arrear is prepared and is duly certified by the Committee.
- (5) See that Subscriptions received in advance, if any, are duly adjusted and all outstanding liabilities for expenses are properly brought in.
- (6) Vouch the receipts in regard to catering, bar and billiard room with due regard to any internal check that may exist.
- (7) See that a proper control is maintained on purchases of wines, spirits, tobacco, provisions, etc., and that all such purchases are supported by duly authorised Invoices.
- (8) See that the Stock Sheets are duly certified as to take and valuation.
- (9) Examine also the minutes of the managing committee or the governing body to see that all matters relating to accounts have been given effect to.
- (10) See that the Lease of the premises, furniture and fittings, plate, china and linen are adequately depreciated.
- (11) Verify the club's investments and other properties and assets in the usual way.

LANDED ESTATES

- (1) All original acquisitions should be verified with Conveyance Deeds and Solicitor's Bills of Costs. In case of Leaseholds, the agreements of Lease should be seen.
- (2) The collection of rents should be vouched from counterfoils of Bill Books into the Cash Book, and thence from the Cash Book into the Rent Roll or Tenants' Register.
- (3) The arrears of rent must be tallied in total with the List of Arrears as made out from the Rent Roll, and must be certified by the Manager.
- (4) All expenses such as Municipal Taxes, Insurance, etc., must be vouched with their duly receipted bills.
- (5) All repairs to buildings must be carefully scrutinised and duly authenticated.

(6) Any leases or agreements with the tenants should be inspected to ascertain the terms of tenancy, and it should be seen that all amounts periodically due are properly brought in.

(7) If there are any farms or agricultural lands attached to the estate, see that the sale proceeds of produce from these are properly recorded and brought into account.

(8) See that all outstandings of rents are duly carried forward in the Rent Roll.

(9) See that all outstandings on account of Sale of Produce are properly brought in.

(10) In case of sale of land or any property, verify the transactions with the corresponding Sale Deed.

CHARITIES

(1) The constitution of the Charity and the rules and regulations relating thereto must be examined.

(2) The auditor should see that the specific conditions attaching to any funds are faithfully carried out.

(3) All donations and subscriptions received as shown in the Cash Book should be vouched with their corresponding counterfoil receipts, as also with the Subscription and Donation Lists periodically advertised.

(4) Verify carefully the purchase of all fresh investments, and additions to assets.

(5) Obtain the banker's certificate as to the lodgment of all securities at the close of the financial period.

(6) In case of any properties belonging to the charity, see that proper Rent Rolls are maintained and all rents are duly accounted for.

(7) Examine the minute book of the Trustees or the Managing Committee in regard to important transactions as would affect accounts.

(8) See that dividends and interest from investments are periodically brought into account.

(9) See that all grants from the charity are supported by proper minutes of the Managing Committee or the Trustees.

BRANCH ACCOUNTS

The extent to which Branch Accounts should be examined will depend largely on the system of accounting employed at the Branches. But whatever the system may be, there should be a strict uniformity of the method of recording at the various Branches, and the auditor should see that the Head Office instructions in this behalf are adhered to rigidly.

Where the collections of their sales moneys are made by the Branches locally, detailed checking will have to be done by the auditor to satisfy himself that all these have been duly accounted for.

Where the system is for the Branches to report their Sales to the Head Office which does the collection, it would become necessary to see by reference to Despatch Book or Shipment Book that all Sales are properly reported to the Head Office.

If the remuneration to the Branch managers takes the shape of a percentage in the net profits of the Branches, it should be seen that the profits are not wrongly inflated by deliberate over-valuation of stock, and special enquiry will have to be made as to the valuation of shop-soiled or obsolete stock.

Where the terms of engagement do not include personal visit to the Branches, the auditor may suggest Returns from such Branches to be audited and certified by local Auditors.

The system of recording of Branch transactions in the Head Office Books should be studied in all its details. In some cases, each Branch maintains a complete set of books and furnishes periodical Returns to the Head Office regularly, and these are then incorporated in the Head Office books. In such a circumstance, the auditor should ascertain definitely what system of internal control on the recording of the daily transactions obtains at each Branch. There will be a regular current account between the Head Office and each Branch, and these should be reconciled at periodical intervals. The auditor should see that all periodical Returns are accompanied by their supporting vouchers and are not available to him for verification, he must make a specific mention of this fact in his Report. Where the Branch Returns are certified by local auditors, the Head Office auditor need not concern himself with the vouchers appertaining to the transactions at the Branches.

In some cases, the Head Office is supplied with complete duplicates of all the records maintained by the Branches, including records of daily cash receipts and disbursements, purchases, sales and even Ledger accounts. Such a method greatly facilitates instant references to any Branch transactions. Besides, a detailed audit of the transactions of each Branch is thus rendered possible at the Head Office and a close check is maintained on the Branches.

A good check, in any case, would be to instruct the Branches to deposit their daily receipts in a Bank account opened in the name of the Head Office, and to meet all payments by means of cheques from the Head Office. The necessary amount of Petty Cash would, of course, be left with each Branch on the Imprest System. The auditor will have to check the amounts shown as deposited, from the Branch Returns into the Head Office Pass Book.

Where the auditor has accepted the certificates of Branch Officials in the matter of stock quantities and valuation, reserve for doubtful debts,

existence of all assets and liabilities at Branches and the proper inclusion of outstanding liabilities for expenses, he should for his own protection mention such fact in his report, and thus limit his responsibility.

Occasionally, goods sent by the Head Office to the Branches are invoiced at Selling Price, and, in such a circumstance, the auditor should satisfy himself by proper enquiries that the values of closing stocks at the Branches have been reduced to cost or market price. This will call for the verification of the necessary adjusting journal entries made in this behalf.

The transactions between one branch and another will also call for the auditor's attention, and this will necessitate the proper reconciliation of current accounts between the Branches.

The current account of each Branch with the Head Office should be checked and reconciled, and it should be seen that the difference, if any, relates only to goods or cash in transit.

Where the Branches are located in foreign countries, a very important point to be looked into by the auditor would be the question of exchange. The auditor should see that the periodical Returns or the Trial Balances of the Branches are converted into the Head Office Currency on some consistent and equitable basis. Where the rate of exchange between the Head Office and the Branch is sufficiently stable, all the other accounts excepting the remittances may be converted at a fixed rate of exchange. The remittances would already have been recorded in the Head Office books at the amounts actually received or remitted. Where the exchange fluctuates, the fixed assets would be converted at the rates at which they were actually acquired, and the current assets and liabilities at the rate prevailing at the close of the financial period. The revenue items, in such a circumstance, would be converted at an average rate of exchange during the period under audit. Any difference arising from the conversion of the several items at different rates of exchange would be placed to an account styled Profit or Loss on Exchange.

The auditor should obtain lists of Branch Debtors duly certified by the respective Branch managers.

Debit or Credit Balances of the Branches should be shown distinctly on the Head Office Balance Sheet, and not mixed up with Sundry Debtors or Creditors.

In case of any irregularities at the Branches or any of the Head Office instructions not being carried out, it would be the auditor's duty to bring the matter to the notice of the Head Office.

AUTOMOBILE DEALERS

(1) The dealer's contracts with the manufacturers should be examined to ascertain the terms and conditions of purchase.

(2) If any advances are paid as deposits against purchases, see that the same are duly credited in the statements from the manufacturers.

(3) See that interest, if any, receivable on such deposits, is duly collected.

(4) Deposits received from customers against orders should be properly verified and shown under its distinct head as a liability in the Balance Sheet.

(5) The purchases of cars should be verified with their corresponding Invoices and also into the manufacturers' Accounts.

(6) See that all new cars purchased and sold are entered in a Cars Register, so that the checking of unsold cars on hand may be facilitated.

(7) See that the record of second-hand cars is kept separately, and not mixed up with that of the new cars.

(8) Where old cars are received from customers on sale of new cars to them, see that such second-hand cars are not brought into the books at anything beyond the allowance made to the customers and the cost of overhauling them.

(9) Examine carefully all debits to customers for cars sold and their subsequent realisation.

(10) In order to verify balances due by customers at the close of the financial period, it is highly desirable that a statement of amount payable as per the Ledger should be sent to each customer requesting him to communicate directly with the auditors in case of any discrepancy or irregularity.

(11) All allowances payable to customers on balances due by them should be provided for.

(12) Balances due to manufacturers at the close of the period should be verified with their statements of accounts.

(13) All bills sent out to customers for repairs and supply of accessories should be verified.

(14) Inquire into the internal check in the Repairs Works as to the record and payment of wages, and the receipt and issue of materials and stores.

(15) Check the Certified Inventories of New Cars unsold with the New Cars Register, and carefully enquire into the mode of valuation.

(16) Verify the certified list of Second-hand Cars on hand with its corresponding Register, and see that in no case is any car valued beyond its actual cost to the dealer.

(17) See that proper provision is made in respect of depreciation in value of Old Models on hand.

(18) Obtain a certificate signed by the Repairs Works Manager as to the proper valuation of work-in-progress.

(19) Where cars are sold on Instalment System, see that a proper record is maintained of all such instalments due and received, and inquire thoroughly into any such instalments overdue.

(20) See that interest receivable on the Instalment Sales is duly apportioned over the period covered by the Instalments.

(21) See that Customers' Cars for Sale are not included in the stock, and that such sales are credited to the customers concerned, and not to Sales Account.

(22) Obtain a Certified Inventory for Cars on Hand and verify the prices with the Cars Register.

(23) The Certified Inventory for Stores and Spare Parts should be scrutinised to ensure that all obsolete parts are ignored for purposes of valuation.

(24) Cars on consignment with the dealer should be recorded distinctly from the dealer's own cars for sale.

MANUFACTURING BUSINESS

(1) The auditor should carefully enquire into the system of purchasing, recording and payment of materials and stores, the control over issue of materials and stores, and the recording and payment of wages.

(2) The system of receiving materials and stores, and the checking of invoices as to quantity, quality and the rates charged should be specially looked into.

(3) He should also ascertain what control there is over stocks of materials and stores and the system of stock-taking. The proper valuation of these should receive special attention.

(4) The method of providing proper depreciation on Buildings, Plant, Tools, Designs and Patents should be enquired into.

(5) All allocations between Capital and Revenue Expenditure should be certified by the Works and General Managers, and it should be seen that items appertaining to repairs and replacements are not wrongly capitalised.

(6) Enquire carefully into the mode of valuation of work-in-process of manufacturing.

(7) The basis of valuation of finished products should receive careful attention.

(8) A thorough enquiry should be made into the costing system in use, and the reconciliation of cost account results with those indicated by the financial records should be scrutinised.

(9) The question of liability on forward contracts for the purchase of raw materials at certain prices extending beyond the period of Balance Sheet must be considered.

(10) See that the Wages Sheets are properly made out and certified, and vouch all wage payments.

(11) Examine Board's minutes sanctioning all Capital Expenditure.

EDUCATIONAL INSTITUTIONS

(1) Trust Deed, if any, should be inspected to ascertain the mode of management and provisions affecting annual accounts.

(2) If there is a Managing Committee or a Governing Body, the auditor should go through the minutes of their meetings in order to see that the resolutions affecting accounts have been duly complied with.

(3) Fees recovered should be verified with the Register of Students and also checked from counterfoil-receipts into the Cash Book.

(4) See that Fees, Extras, etc., irrecoverable and written off as such are duly authorised by the Managing Committee.

(5) See that Fees received in advance are carried forward.

(6) Proper authority should be seen for free enrolments or those at reduced fees.

(7) Enquire into the system of recording of extras chargeable to students.

(8) The collection of extra charges for diplomas, examination fees, laboratory or school supplies, etc., should be specially scrutinised.

(9) Any failure of records to control adequately the collection of tuition fees, dormitory rents, board and extras should be brought to the notice of the Committee.

(10) Income from Landed Properties, if any, should be duly verified with Rent Rolls.

(11) Investments should be verified by actual inspection or with Banker's Certificate.

(12) All Establishment Expenses should be vouched in the usual way, and, if there is any unduly heavy expenditure under any head, the same should be properly enquired into.

(13) Any increase in the Staff Salaries should be duly sanctioned and minuted.

(14) Any Capital Expenditure, incurred during the period under audit, should be verified with the minutes of the Committee.

(15) Inquiry should be made into the system of buying of provisions, food-stuffs, clothing and other equipments for boarders, and whether there is proper internal check on the payment of such bills.

(16) Donations should be carefully verified with the announcements in the annual report, and in case of funds endowed for any specific purpose, the auditor should see that the income therefrom has been applied towards the purposes as required by the donors.

(17) Proper certified inventories should be obtained in respect of furniture and other equipment and stocks of stationery, provision, etc.

(18) The auditor should suggest inclusion of accrued income in respect of outstanding fees and accrued interest on investments, as also outstanding liabilities for expenses incurred and not paid, in the annual accounts instead of the latter being presented on cash basis.

(19) If the income from the funds endowed for specific purposes is not being applied towards the objects designated by the donors, the auditor must disclose the fact in his certificate.

(20) Grants from Government, if any, should be verified.

(21) See that all outstanding Assets and Liabilities are duly brought in the Balance Sheet.

MOTOR-BUS COMPANY

(1) Ascertain system of Internal Check, particularly in respect of record of Passenger and Advertising Receipts.

(2) Test Passenger Receipts with Traffic Register.

(3) Vouch Advertising Receipts with Contracts and Returns from Agents.

(4) Verify all purchases of Vehicles and Stores.

(5) Where Buses are acquired on the Hire Purchase or Instalment System, see that proper allocation of Interest is made while recording payment of each Instalment.

(6) See that all Repairs and Maintenance Charges are duly certified by the Works Engineer, and that these are charged to Revenue.

(7) Ascertain that a proper system of Internal Check exists in respect of issue of Tyres, Tubes, Petrol and other stores.

(8) Enquire if a proper record is maintained of the repairs and working costs of each Bus.

(9) See that a proper system of recording and payment of wages obtains in the Repairs Workshop.

(10) See that ample provision for Depreciation on Buses is made. Where tyres, motors and renewals of large parts are charged to revenue, a reserve of 15 to 20 per cent is considered to be sufficient to cover depreciation on Buses as a going concern.

(11) Obtain certified Inventories of Stock of Stores, Petrol, Oils, Buses and Plant.

(12) Vouch carefully all Capital Expenditure and see that the same is duly authorised and sanctioned.

(13) See that a proper Register of Buses is maintained indicating those in use, and those discarded or sold.

(14) While considering the question of Depreciation, due allowance should be made as to the chances of any type of Buses becoming obsolete.

PUBLIC TAXI COMPANY

(1) See that there is a proper system of daily recording of meter-reading, of total mileage done and revenue receipts of each Taxi.

(2) See that the Revenue Miles run as indicated by the meters are duly accounted for by the driver of each Taxi.

(3) Make test checks of the entries from some of the Daily Cards provided to the drivers recording the mileage run by comparison with the Daily Register of Taxi-meter Readings.

(4) See that a proper Internal Check and Control is provided over the issue of Tyres, Stores, Petrol, Lubricants, etc., to the taxi-drivers.

(5) Carefully verify all purchases of Cars and trace them into the Register of Taxis.

(6) In respect of such Taxis as are acquired on the Instalment or the Hire-Purchase System, see that each payment is properly allocated between Principal and Interest.

(7) See that the Repairs Works are properly organised, there is a proper control over wage payments and issue of stores, and the repairs to each Taxi are duly ascertained and registered.

(8) See that Repairs are not unduly capitalised.

(9) Obtain a certified list of Taxi-Cars in use.

(10) Obtain certified Stock-Sheets of Stores, Tyres, Tubes, Petrol, etc., on hand.

(11) See that sale of any discarded Taxi is not wrongly credited to Sales Account.

(12) Verify all capital expenditure and see that the same is duly authorised.

DEPARTMENT STORES

(1) See that there is a proper grouping of the different lines of stores, that the general management and control are properly organised so as to reduce the possibility of fraud or errors to a minimum, and that the accounting of the business as a whole is based on efficient lines.

(2) Ascertain the system of Internal Check on the record of the daily enormous Cash Sales.

(3) Make Test Checks covering some selected periods, by comparing the Sales from the Cash Memo Books into the Daily Sales Summaries.

(4) Check the entries of the daily totals of the Sales Summaries into the General Cash Book.

(5) Enquire if there is proper Internal Control over the ordering and purchase of merchandise required by the different Departments, whether the goods are checked on receipt with their corresponding Invoices, and whether the latter in their turn are duly checked as to prices, calculations and extensions before being entered up.

(6) See that all Purchase Invoices are passed by some one in authority before payment.

(7) See that full advantage is taken of Cash Discounts, and that proper rebates or allowances are obtained for all shortages in quantity or weight, or for defects in quality.

(8) Invite the attention of the management to any deficiency or weakness that you may discover in any part of the organization or system of record.

(9) Verification of Salaries and Wages would form an important item for close scrutiny and checking.

(10) Check carefully the system of ascertainment of commission payable to those in charge of the Sales.

(11) A comparative study of the Departmental Results particularly the percentage of gross profit on Sales with the preceding period will bring to light several points, what would call for specific enquiries.

(12) See that the common expenses relating to general administration are distributed over the different Departments on some equitable and consistent basis.

(13) Enquire carefully into any violent fluctuations in the ratio of selling expenses to sales.

(14) Obtain Inventories of Departmental Stock duly certified by the Departmental and General Managers, as to the correctness of quantities, prices and mode of valuation.

(15) Ascertain that old, shop-soiled or unsaleable stock is not valued beyond its likely realisable price.

(16) Test the prices of some of the costly items from the Stock Inventories into their relative purchase Invoices.

(17) Where Stock Books are maintained, the auditor should make a test checking comparing the quantities of some important items in the Stock Sheets with those indicated by the Stock Records.

CHAPTER XIV

THE AUDIT OF COST ACCOUNTS

On account of the increasingly competitive conditions under which our industries have to labour, the internal economy of their businesses has now become the vital problem with our manufacturers, and the necessity of a reliable system of Cost Accounts as an integral part of their organisation is slowly beginning to be felt by them. It is evident, therefore, that with the advancement of our industries in course of time, the services of professional auditors will be more and more requisitioned with a view either to install a suitable system of Cost Accounts, or to examine the system already in use, report upon its inefficiencies, and suggest ways and means of improvement to bring it on a line with the special needs of the business. It thus becomes necessary that the auditor should thoroughly acquaint himself with the intricacies of this vast subject which plays such a dominant part in the successful management of every industrial enterprise.

THE OBJECTS OF COST ACCOUNTS

While introducing a new system or suggesting necessary improvements in the one already existing, the main objects of Cost-finding must always be borne in mind. They are—

(1) To ascertain accurately the total cost of each product, process, job or other unit of production in all its constituent elements ;

(2) To enable a check and control to be maintained on the whole of the expenditure by a detailed analysis and classification thereof with due regard to the productive and non-productive factors;

(3) To serve the manufacturer as a guide in deciding upon his price-fixing policy;

(4) To enable reliable estimates based on past experience and records to be prepared for giving quotations or filling in tenders, subject of course to any prospective changes in market prices of materials and labour, or any likely change in overhead expense ;

(5) To indicate to the management any inefficiencies in the use of machinery, equipment, material, or labour, and to invite attention to any wastage arising therefrom;

(6) To reveal sources of economies in production by way of necessary changes in designs, tools, methods of production or output;

(7) To provide reliable and comprehensive data for comparison of costs of different production units from period to period, and also to indicate how the actual costs of performance compare with the estimates; •

(8) To provide a reliable control on the large amounts expended on the materials and stores received and consumed, and the wages paid;

- (9) To ascertain which sections of the business are profitable and which are not;
- (10) To serve as a check on the results as expressed by the Financial Accounts; and
- (11) To reveal defects in any section of the organisation as a whole.

INSTALLING A NEW COSTING SYSTEM

In view of the above objects, the auditor would do well to study most carefully the nature of the business and its special requirements, the manufacturing process involved, and the division and sub-division of the productive and non-productive sections of the organisation, before he devises a system when called upon to do so. The following points would, however, need to be kept in view in all cases:—

(1) The system should be simple, practicable and elastic so as to be capable of adjustments as and when occasions arise.

(2) The accountant in charge of the Cost Department must be conversant with the intricacies of cost accounts and must be capable of grasping the manufacturing technique of the particular business so that he may know how best to collect, classify and allocate the expenditure in shape of materials, labour and expense in order that the same may be equitably recovered from the productive units.

(3) The system must admit of the fullest co-operation of the Cost Office with the technical, commercial and financial departments of the business.

(4) There should be a proper standardization of all Cost Records and Forms, and uniformity in size of all Cost Statistics and Forms as far as possible.

(5) A clear distinction should be drawn between the Forms and Statements to be used in regard to information for *Direct* Material, Labour and Charges from those to be utilised in respect of *Indirect* Material, Labour and Expense, by the use of either different tinted paper or by printing in different coloured inks.

(6) There should be a close co-ordination and inter-locking of all productive and non-productive activities of the concern and a sound system of Internal Check so as to facilitate prompt and reliable getting in of all the necessary information for the purposes of costing.

(7) The periodical results as shown by the Cost Accounts should be capable of being reconciled with those shown by the Financial Accounts.

(8) In order that the system may prove a profitable investment, it should not be unnecessarily elaborate or disproportionately expensive.

(9) The system of record and filing should be so shaped as to permit of ready comparison of similar jobs or processes already performed from time

to time, so that the causes for any excess over the pre-determined costs may be traced and any waste of material, labour or expense may be brought to light.

While introducing a system of Cost Accounts, the auditor should see that all the above requirements are duly fulfilled thereby, and that it really helps the management towards securing greater efficiency and control in economic costs.

COST AUDIT

On an auditor being called upon to conduct an examination of Cost Accounts already prepared, he must determine upon his programme of procedure after entering into a detailed inquiry into the nature of the industry and the system of organization in existence, in order to ascertain how far the latter fits in with the particular requirements of the business in view. He would then study the costing system already in use and the available cost records and other data to find out to what extent the various statements of analysis and statistical information supplied to the Cost Office can be held to be reliable. This will necessitate inquiries into the several checks and counter-checks that may have been installed in order to ensure that the recording, classification and allocation of the voluminous transactions in relation to material, labour and expense have been carried out on correct and logical lines. It would be a good plan for him to make notes of any weak points that he comes across in course of his inquiries to enable him to base his report thereon. He will then proceed to a critical examination of the Prime and Total Costs placed before him.

VERIFICATION OF DIRECT MATERIALS CONSUMED

In regard to the system of Internal Check that may exist in the concern in connection with the incomings and outgoings of materials, his inquiries must relate to the ascertainment of the following facts:—

- (a) As to who authorises the purchases, and how the materials are ordered out;
- (b) What system of check there is in regard to the verification of the goods actually received from time to time;
- (c) How the Inward Invoices are checked on receipts in regard to the quantities and prices;
- (d) Whether the entering up of the Goods Received Notes by the Chief Storekeeper is made independently without any reference to the corresponding Invoices ;
- (e) What system there is in regard to the use of Material Issue Requisitions;
- (f) What check there is on the pricing of Goods Received Notes and Issue Requisitions as carried out by the Stores Accountant;.

- (g) Whether there is a system of continuous checking of actual quantities of stock with the relative Bin Cards, and the checking of the quantities as shown by the latter with the corresponding Stores Record Cards; and
- (h) On what basis are the materials issued to the Departments or Jobs priced.

The auditor will then proceed on a detailed and a sufficiently comprehensive test check to satisfy himself as to the accuracy of the charges to the several Job Accounts in regard to the issues of Direct Material. This will include—

- (1) A comparison of a few Material Specifications with the relative Works or Stock Orders to ascertain how far the materials actually issued out and charged thereto as shown by the Cost Accounts compare with the quantities mentioned in the Specifications.
- (2) Checking of a good number of Material Issue Requisitions into the Materials Issued Summary.
- (3) Checking of the periodical totals from the Materials Issued Summary or Material Abstracts with the debits to the relevant Works Order Accounts in the Job Cost Ledger or the Cost Sheets.
- (4) A detailed examination of some of the Materials Issue Requisitions to ensure that—
 - (a) The Requisitions are properly dated and signify the relative Departments or Works Order Numbers;
 - (b) The quantities and values are properly entered;
 - (c) The relevant Bin and Stock Record Card Numbers are entered thereon; and
 - (d) Each such Requisition is duly authorised and signed.
- (5) Checking the pricing of some important items of Material Issues to ascertain that a correct and consistent method is followed in relation thereto.
- (6) A test check of some of the transactions relating to Returns of Materials to Stores and Transfers of Materials from one job to another.
- (7) A test check of some of the quantity balances as shown by the Stores Record Cards with their corresponding Bin Cards.
- (8) A general inquiry into how scrapped material and spoilt work have been dealt with.
- (9) An agreement of the total issue of Direct Materials charged to the Cost Accounts for the period with the total issues for the same period as disclosed by the Financial Records.

The above verification will involve an examination of the following vouchers or records:—

- (a) Material Issue Requisitions for issues from Stores;
- (b) Purchase Invoices or Purchases Journal for materials specifically purchased for any Works Order and which have not entered the Store-rooms;
- (c) Material Specifications issued with Works Orders;
- (d) Scrapped Material Register;
- (e) Material Returned and Material Transfer Notes;
- (f) Bin Cards and Stock Record Cards;
- (g) Bin Inspection Cards;
- (h) Materials Issued Analysis, Summary, or Abstract.

ISSUE REQUISITIONS FOR DIFFERENT PURPOSES

A vital point in connection with the checking of Issue Requisitions is for the auditor to see that the issues for different purposes are clearly distinguished one from the other by the use of different coloured paper or by printing in different coloured inks so as to obviate all chances for errors. There will thus be distinct types of Requisitions for the following:—

- (1) For supplies of Direct Materials used on Works Orders or Stock Orders, as these will form part of the Prime Costs.
- (2) For supplies of Direct Materials required for Capital Outlay such as erection of new building or plant, manufacture of costly tools, patterns, or other equipment, or extension or improvement to any existing structure or plant. These will be charged to the cost of the asset accounts concerned.
- (3) For supplies of Direct Materials to replace the original quantities, issued in case of spoilt work and chargeable to "Defective Work Account".
- (4) For supplies of Indirect Material for repairs and maintenance to Works Building, Plant, Tools or other Equipment, as also consumable stores such as beltings, oils, brushes, lubricants, cotton waste, etc. issued to different Departments or Services, and chargeable to Works Expenses.
- (5) For supplies of Indirect Material for any of the purposes of capital outlay as mentioned in (2) above.
- (6) For supplies of Indirect Material chargeable to administrative and selling oncosts.

VERIFICATION OF MATERIALS AND STORES RECEIVED

The checking of the materials and stores purchased and received will be carried out by the auditor in the same manner as is ordinarily done in

any concern while verifying the entries in connection with the accounts of the Suppliers, and which has already been described in the earlier portion of the work. It does not, therefore, call for any special comments here. The checking must also include a detailed examination of some of the items from the Goods Received Notes into the corresponding Invoices, and also into the relative Bin Cards and Stock Record Cards.

VERIFICATION OF DIRECT WAGES

A careful and exhaustive scrutiny of the Direct Labour paid must include the following:—

- (1) A general inquiry into the system of remunerating labour;
- (2) An inquiry as to who is responsible for fixing the wage-rates and bonuses;
- (3) What system of Internal Check there is in connection with the time and performance records, and the preparation and payment of wages, and that all the regulations in connection therewith have been strictly adhered to;
- (4) Whether the classification and allocation of wages are made on right and consistent basis;
- (5) A test check of the timings as shown by the Job Cards, Time Sheets or Wage Tickets with the punchings on the relative Clock Cards;
- (6) A comprehensive checking of the wage amounts from the Job Cards or Wage Tickets into the Direct Labour Abstracts;
- (7) A similar checking of Piece-work Cards into the Piece-work Register, and from the latter into the Direct Labour Extracts;
- (8) A checking of the wages from the Direct Labour Abstracts into the Job Cost Summaries or the accounts of the Jobs in the Job Cost Ledger;
- (9) An inquiry into how the labour expended on spoilt work is recorded;
- (10) An inquiry into whether overtime has in all cases been duly authorised;
- (11) Ascertainment of how Idle Time has been dealt with;
- (12) A scrutiny to ascertain that all deductions in respect of fines, rent, insurance, advances, etc. have been duly made before arriving at the net amount payable in each case;
- (13) That all Job or Piece-work Cards, Wage Tickets, Wages Sheets and Wage Allocations are duly signed by those in authority.
- (14) Where the costing system is linked with the Financial Accounts and is maintained under Double Entry, the auditor must see that the Direct Material and Direct Labour of each period as indicated by the Financial Books are all recovered in costs as shown by the

Cost Summaries of the same period. In the absence of any such facility for reconciliation, he must have Total or Control Accounts for Direct Materials and Direct Wages prepared for his own satisfaction.

The records and vouchers that would be needed by the auditor in connection with the above checking will be—

- (a) Time-keeper's Record or Clock Cards of direct workers;
- (b) Time Sheets or Job or Operation Cards;
- (c) Piece-work Cards or Sheets and Piece-work Register;
- (d) Foremen's Weekly Analyses of work done;
- (e) Direct Wages Analysis or Wage Abstracts;
- (f) Scrap Reports disclosing labour expended on scrapped material; and
- (g) Registers of Over-time and Idle Time.

SEPARATE WAGE ABSTRACTS FOR DIFFERENT PURPOSES

The auditor should see that a clear distinction is drawn between the Direct and Indirect Wages, for whereas the former would form part of the Prime Cost of each cost unit, the latter would be included in the Works Overhead duly classified under the different types of non-productive services and other auxiliary work performed. He must further scrutinise the Wages Analysis to ensure that the Direct and Indirect labour involved in any work of a capital nature are clearly distinguished from other wages and that they are treated as capital expenditure and added to the cost of the assets concerned. In any well-organised concern, he would expect separate Wages Analysis Sheets prepared in respect of the following:—

- (1) Wages expended on capital additions to Buildings, Plant or other Equipment;
- (2) Direct or Productive Wages for inclusion in the Prime Costs of the products;
- (3) Indirect Wages expended on repairs and maintenance of Buildings, Plant and Implements, as also on other auxiliary services and sundry factory labour forming part of the Works Oncost; and
- (4) Indirect Wages forming part of the administrative and selling oncosts.

VERIFICATION OF DIRECT OR CHARGEABLE EXPENSES

Expenses incurred specifically on account of a particular cost unit and which can be definitely allocated thereto would be chargeable directly as part of its Prime Cost. The auditor should verify these with the weekly or monthly analytical lists of Chargeable Expenses prepared by the Financial Department and passed on to the Cost Office, and see that the correct Job Accounts are charged therewith, and that all such chargeable expenses are duly recovered in costs for the period.

The following items usually come under this head:—

- (1) Cost of patterns, drawings or designs specifically prepared for a particular job and which cannot be utilised for other purposes;
- (2) Hire of special machinery, plant or other equipment such as portable cranes, traction engines, scaffolding, etc.;
- (3) Architects' and surveyors' fees incurred in connection with some particular contract or job;
- (4) Travelling expenses and substance allowances incurred by experts and others in supervising or reporting on work executed away from the works;
- (5) Cost of any experimental work carried out specially for a particular job; and
- (6) Cost of carriage or freight inward incurred on supply of special materials directly to the job.

Such expenses are usually incurred when a concern undertakes some outside constructional work far away from the works.

VERIFICATION OF OVERHEAD CHARGES

The whole of the expenses of any manufacturing business can be divided into three main classifications:—

- (1) Administrative Expenses.
- (2) Factory Expenses.
- (3) Selling and Distribution Expenses.

ADMINISTRATIVE EXPENSES represent such items of expenditure as relate to the general and financial administration, direction and control of the undertaking.

FACTORY EXPENSES include the cost of indirect material and consumable stores, indirect labour and all indirect expenses incurred in the running of the works.

SELLING EXPENSES consist of items of expenditure which relate to the running of the Sales Department and other efforts spent towards securing orders and retaining markets.

DISTRIBUTION EXPENSES would relate to the cost of distribution of the factory products.

The proper allocation and distribution of the expense burden or overhead cost to the individual job, group of products, process or department presents an extremely difficult problem. As the fundamental object of Cost Accounts is to arrive at the accurate costs of the products, it is highly necessary to see that each product, process or unit gets a fair portion not only of the direct material and labour involved, but also of the expense burden attributable thereto. It is very evident that although the overhead

charges may be correctly enumerated, any improper allocation of this factor to the prime cost of products will leave unfulfilled the principal object of costing, and will give results far from accurate. So far as direct materials and direct labour are concerned, the exact amount consumed or expended in the production of any one product or a group of products can be definitely measured and most accurately determined, and as the items can be specifically attributed to particular jobs or products, the allocation in this respect can be easily made weekly or monthly as found suitable.

The question of oncost, however, presents several difficulties. The first problem is to ascertain the actual oncost expenditure for any given period. The term Oncost comprises in its widest sense all the expenses (excepting direct material, direct labour and chargeable expenses) incurred in production and distribution, including repairs to plant, buildings, tools, and provisions in respect of depreciation, bad debts, etc. Now, it is evident that items like taxes, repairs, bad debts, salesmen's commission and travelling expenses, advertising, experimenting expense, agency and branch expenses, legal costs, etc., cannot be exactly ascertained till the end of the financial period, and yet for the purposes of getting at the total cost of each product on its completion, it becomes necessary to charge to the prime cost of that product a percentage in respect of factory oncost and another in regard to office oncost. Besides, the items covered by oncost are so numerous and varied in their nature that they will not admit of being dealt with in the same manner. Further, the items relate to general services auxiliary to the main function of production, and are, therefore, not specifically expended upon any particular item of production or job. In most cases, it becomes difficult even to say definitely the exact portion of each class of overhead burden which is attributable to each process, operation or department of the factory, let alone to each job. Evidently, therefore, the ascertainment and allocation of the oncost burden resolves itself into a matter of estimate, but such estimate must be done on most scientific and efficient lines so as to give results bearing closest approximation to actual conditions. It is in the distribution and apportionment of these Overhead Expenses, therefore, that the most difficult problems in costing are met.

To begin with, a careful classification of all the overhead expenses of the business must be done on systematic and natural lines of division, as this would help considerably towards the ascertainment of the total oncost as also its subsequent apportionment. It is equally important to note that the division of the nominal accounts indicating the heads of expenditure in the financial books should be made on similar lines so as to admit of useful comparisons.

Having prepared separate classified statements of expenses, viz., of Administrative, Factory, and Selling and Distributive Overheads, the amounts actually expended during the immediate preceding year under each of those heads analysed into appropriate sub-heads should be set out. Neces-

sary adjustments should then be made to any of these items in respect of any anticipated increase or decrease during the current year, and the result will be the estimated probable oncost expenditure of the period based on a definite output. These expenses may then be sub-divided into shorter periods, say months, and the monthly oncost burden thus ascertained should be distributed over the different departments of the works on some reasonable and consistent basis with due regard to the actual facts and circumstances. But these figures should then be subjected to a close scrutiny and tested in the light of actual facts to see how far they are in agreement with the amounts actually expended under each head at the close of the financial period, and, if possible, at shorter intervals.

In a manufacturing business where there are several distinct departments working under different conditions, it is absolutely essential for an equitable division of oncost to ascertain the works expense attributable to each such department. Each department should be treated as a distinct entity, and the particular conditions obtaining in each and the class of the work done therein should be closely examined and taken into account before deciding upon the method of allocation of each departmental oncost. There are instances where different methods of oncost allocation are found necessary in different departments of the same business.

Another vital point that needs to be stressed is that apart from the division of the entire works into productive departments or sub-departments, there should be a systematic division of the non-productive work carried on by the several auxiliary services. The expenses incurred in connection with the running of each such Service must be separately recorded with the help of Service Order or Works Expense Order numbers. It is then only that a reliable basis would be obtained for the accurate record of the numerous expenses and their proper division and distribution amongst the various productive activities of the business in true relation to the incidence of each such expense.

In view of the above difficulties, the auditor must devote the greatest care, precision and intelligence to ensure that the collection, classification and allocation of the Overhead Expenditure are made on correct lines and that the whole of such expense for any given period has been accurately absorbed in the different sections of the oncost calculations for the same period. It is here that most of the factories lose touch with their costs and fail to secure reliable results, and it is here that the auditor's services would prove most helpful and beneficial, if he performs his duties conscientiously.

APPORTIONMENT OF WORKS AND ADMINISTRATIVE EXPENSES

An important duty of the auditor would be to satisfy himself that the methods utilised for the allocation and apportionment of the Works and Administrative Expenses amongst the productive departments and auxiliary services are consistent, sound and reasonable with due regard to the nature

and requirements of the business. He must also make inquiries to ensure that constant comparisons are made between the estimated figures of oncost taken for costing purposes and the amounts actually expended under the different heads as shown by the Financial Books, and any appreciable differences thus brought to light are duly adjusted in the future Costs.

BASIS FOR APPORTIONMENT OF EXPENSES

The following schedule will help to indicate the manner in which the varied items of expenditure are usually apportioned over the several departments or productive and non-productive sections of the business:—

1. Rent and Taxes	According to floor-space or values of buildings occupied.
2. Fire Insurance	
(a) Buildings	According to floor area occupied.
(b) Plant and Machinery	Capital values.
(c) Employers' Liability	Total wages in each department.
3. Building Expense	According to area or capacity of Buildings.
4. Electricity	
(a) Power	In proportion to H.P. hours in each section, or consumption return.
(b) Lighting	According to number of lights or meter, or floor area.
5. Repairs and Maintenance	Direct analysis.
6. Indirect Material, i.e. (Consumable Stores)	Direct analysis.
7. Stores Expense	According to values or weights of issues, or number of requisitions, as may be found suitable, or on basis of direct wages in operating departments.
8. Heating	Floor area or cubic capacity of departments.
9. Steam, Hydraulic Power and Compressed Air	According to consumption either estimated or metered.
10. Gas and Water	According to consumption.
11. Depreciation on Buildings	Actual in proportion to floor-space taken up by each department.
12. Depreciation on Plant and Machinery	Actual in proportion to capital values of plant and machines in each department.
13. Cost Office Expense	Direct Labour hours, or direct wages.
14. Wages Department and Time-keeping Expense	Number of workers in each shop or department, or direct labour amount.

15. Welfare Expense	According to number of workers, or labour hours, or wages in each department.
16. Over-time and Waiting time	Direct Labour-hour, or direct analysis from pay-rolls.
17. Sundry Works Expenses	Direct Labour hours.
18. Works Management	Total wages in operating departments.
19. Indirect Labour	Direct analysis or according to number of workers in each department.
20. Administrative Expense	Direct wages or labour-hour basis, or in ratio of works oncost or works cost.
21. Works Supervision	Direct labour-hour basis, or direct wages.
22. Works Office Expenses	Direct labour-hour basis, or direct wages.
23. Experiment and Research	Direct labour-hour basis, or according to service rendered.
24. Tools Expense	According to direct labour amount of each department or direct analysis.
25. Internal Transport	Direct wages in operating departments.

From the above schedule, it will be clear that what is aimed at is a fair and consistent measurement of apportionment of the varied items of oncost which cannot specifically be said to relate to any one department or the other; with the ultimate object of an equitable distribution of the whole of the expense involved in the running of a factory over its several operating departments.

EXAMINATION OF RECORDS AND STATEMENTS

For a proper verification of the collection, classification and allocation of the expenses, the auditor will have to enter into a close scrutiny of the following Statements and Cost Records:—

- (1) Summary of Administrative Expenses.
- (2) Summary of Works Expenses.
- (3) Summary of Sales and Distribution Expenses.
- (4) Indirect Wages Analysis or Abstract.
- (5) Indirect Material Analysis or Abstract.
- (6) Allocation of Works Expenses over Auxiliary Services.
- (7) Allocation of Works Expenses over Productive Sections.

Where the Cost Books have been maintained under Double-Entry, there must also be a complete examination of the entries in the following Records:—

- (1) Cost Journal.
- (2) Works Order Ledger, or Job Cost Ledger.
- (3) General Cost Ledger.
- (4) Stores Ledger.
- (5) Finished Stock Ledger.

COST JOURNAL

As exceptionally heavy amounts are involved in the consumption of raw materials, wages, stores and expenses on account of diverse auxiliary services in all large-sized works, it is necessary to maintain even the cost records on the double-entry system so as to ensure a rigid control on the entries relating thereto, facilitate location of clerical errors, and help towards agreement of the cost and financial books.

If the Job Cost Ledger and the General Cost Ledger are to be kept on the double-entry principles, all the entries therein should pass through a Cost Journal. It is through this Journal that all the charges in respect of Material, Labour and Oncost to the various Cost Accounts in the Job Cost Ledger and their corresponding credits to the several accounts in the General Cost Ledger will be passed. Through the same Journal will be passed entries relating to transfers made from one account to another.

The auditor's duty will be to make a comprehensive checking of the Entries in this record to satisfy himself that they are all supported by duly authenticated vouchers and the postings therefrom have been correctly made in right amounts and to the appropriate accounts in the Job Cost Ledger and the General Cost Ledger respectively.

JOB COST LEDGER OR WORKS ORDER LEDGER

There will appear in this Ledger a separate account for each job, works order, a group of products, a productive department, or other unit of production. Each such account would be provided with debit columns for Direct Material, Direct Wages, Chargeable Expenses, Works Oncost and General Oncost so as to indicate details of the component elements in the cost of each job or cost unit. Where need be, further information may be accommodated in respect of "Machine Number", "Number of Machine-hours", and "Number of Man-hours". In many cases, such a provision will greatly facilitate the calculation of the oncost chargeable to any job concerned, where such oncost is allocated on the basis of man-hours or machine-hours.

The credit in respect of any material transferred to other job or returned to stores may be entered on the debit side in red ink and may be deducted

from the total debits, so that the actual cost of the materials consumed may be seen at a glance.

Where it is desired to show profit or loss on each job, a credit column will also have to be provided. The credit column can then be utilised only for showing the Sale Price of each Works Order.

The verification of this Ledger will involve a careful examination of each and every Job Account to ascertain that proper debits have been given in respect of Material, Labour and Oncost. It needs to be pointed out that it is only when a Job is completed that it is charged with its legitimate share of oncost. All incomplete Jobs at the end of the period will be transferred to Work-in-Progress Account and the oncost allocation in respect of all such Jobs will be provided for on Works Oncost Suspense Account and Office Oncost Suspense Account. The credits in respect of returns of materials to stores and transfers to other Jobs will also have to be verified. In regard to completed Jobs, there will be further credits with their relative Sale Prices in order to ascertain the profit or loss on each separate Job or Works Order Account.

As this is not a work on Cost Accounting, it is not possible to give here all the entries, but it is assumed that sufficient details have been presented to enable an Auditor with a good knowledge of Cost Accounting to follow the usual procedure in respect of a complete audit of Cost Accounts.

The auditor will finally satisfy himself as to the correct transfer of profit or loss on each completed Job Account, and the transfer of correct balance of each incomplete Job Account to the Work-in-Progress Account.

GENERAL COST LEDGER

This Ledger takes the place of the Nominal Ledger under any costing system. It will contain all the necessary Total or Control Accounts for the entries appearing in the Job Cost Ledger so as to satisfy the principles of Double-Entry on the one hand, and to form a connecting link between the Cost Accounts and the Financial Accounts, on the other. The accounts to be found in this Ledger will be:—

- (1) Direct Materials Account.
- (2) Direct Wages Account.
- (3) Chargeable Expenses Account.
- (4) Indirect Materials Account.
- (5) Indirect Wages Account.
- (6) Works Oncost Account.
- (7) Office or General Oncost Account.
- (8) Sales Oncost Account.
- (9) Work-in-Progress Account.

- (10) Separate Oncost Suspense Accounts for the amounts attributable to Work-in-Progress in respect of Administrative, Works and Sales Overheads.
- (11) Finished Goods Account.
- (12) Stock of Finished Goods Account.
- (13) Completed Jobs Account.
- (14) Profit or Loss on Completed Jobs Account.
- (15) Sales from Stock Account.
- (16) Profit or Loss on Stock Sales Account, and such other Control Accounts as may be deemed necessary in each particular case.

The auditor will have to exhaustively verify all the accounts appearing in this Ledger to ascertain that they represent an accurate summary of all the Costing Entries relating to the particular period in view, and the final results as disclosed by this Ledger are in close agreement with the results of the corresponding period as expressed by the Financial Records. If there is any appreciable difference, the same should be capable of being explained satisfactorily.

STORES LEDGER

In this Ledger will be recorded all incomings and withdrawals of stores, and the record will thus serve the most useful purpose of controlling the movements of all the articles in the store-rooms. A separate account would be opened in this Ledger for each type and grade of material with rulings as would give the whole of the detailed information as to the quantities received, the issues thereout and the balances on hand from time to time.

The Stores Ledger is usually maintained by the Stores Accountant who is attached to the Cost Office and who enters up the incomings and outgoings of every item of stores independently of any records maintained by the store-keepers. The Stores Ledger will thus provide an independent check on the detailed records kept by the Stores Department on the Bin Cards. Whereas the Bin Cards deal only with quantities, the Stores Ledger or Stores Record Cards will contain records of articles in quantities as also in values. The entering up of the values against the individual items of receipts and the pricing of the Issue Requisitions will be the responsibility of the Stores Accountant.

Experience has proved the necessity of maintaining all the Ledgers and even some of the subsidiary records used for costing on Loose-Leaf Form, or under the Card System instead of bound books, so that several members of the staff may be engaged in writing up any one record simultaneously in order to expedite work. Besides, under the Loose-Leaf or Card System, a continuity of record would be secured by removing the leaves or cards relating to orders or jobs that have been completed, and filing these in a binder kept for such purpose. The current records would thus be relieved of all dead matters, and the annoyance and inconvenience occasioned by

constantly having to turn pages affecting accounts no more in use will be obviated. Further, by the insertion of additional leaves or cards whenever desired, the whole of the information affecting one job or cost unit will be kept together, as there will be no carry forwards to the different portions of the same record as in the case of bound books. All well-organised concerns thus employ most of the principal and subsidiary cost records on the Slip or Card System.

Whereas the auditor cannot afford to carry out a detailed examination of all the entries appearing on each and every account in his Ledger, more especially in regard to Indirect Material and Consumable Stores, he must at least make a comprehensive test checking of some of the important items to ensure that the accounts have been properly extracted and shown on the Stock Lists, and that all discrepancies as disclosed by continuous checking from time to time as also those shown by actual inventory, if any taken at the end of the financial period, are duly rectified and the stock of stores has been adjusted accordingly.

FINISHED STOCK LEDGER

The verification of this Ledger will consist of test checks to ensure that all Finished Products have been duly brought into account and that all issues therefrom to the sales have been properly accounted in the respective accounts concerned. The inventory of Stock of Finished Goods must also be verified with the closing balances as shown by the individual accounts in this Ledger. The question of valuation of the Finished Articles must also receive most careful attention at the hands of the auditor.

RECORD OF EXPENSES IN FINANCIAL BOOKS

In order to ensure that the whole of the administrative, management and works expenses have been recovered from the costs, and also with a view to enable a useful comparison to be made and a rigid control to be maintained over such expenses, it is highly desirable that the accounts relating thereto in the financial books should also be arranged and classified so as to correspond with the periodical cost analysis.

A monthly summary of expenses must be prepared from the financial accounts which in its grouping, classification and sub-division should be on a line with the information required by the Cost Office, and must present as complete and detailed an analysis of expenses as possible. No system of Cost Accounts can be classed as complete and can be relied upon as accurate, if the total expenditure of material, labour and expense for any particular period charged to the costs is not capable of being traced and reconciled with the financial books for the corresponding period.

In the Financial Books, the accounts of the expenses would, therefore, be maintained in close consultation and co-operation with the Cost Office.

so that the monthly summary as obtained therefrom may serve the following purposes:—

- (1) To enable a comparison to be made of the actual current expenses with the scheduled figures as laid down in advance;
- (2) To enable a comparison to be made of each item of expense with the corresponding figure for the preceding month; and
- (3) To secure a means for a close control over the charges incurred by the different Departments as would be evidenced from a further detailed allocation amongst the Departments responsible therefor.

RECOVERY OF WORKS OVERHEAD FROM COST UNITS

The total Works Overhead for each particular period attributable to each department, shop or section of the works having been arrived at, would need to be distributed over the several jobs, processes or group of products worked by each department, shop or section during the period.

There are various methods employed for the purpose of recovering Factory Expenses in costs, but not one of these would be found suitable to all factories and under all conditions. Different methods may be necessary for different concerns even within the same type of industry, as so much will depend on the size of each undertaking, the nature and volume of its business, and the systems of organisation and costing obtaining therein. Sometimes, different methods are utilised in different departments of the same concern, and where the peculiar conditions of work demand it, two or more methods may have to be brought into use in a single department.

The following, however, are the principal methods for the purpose:—

- (1) On the basis of direct (productive) wages paid.
- (2) On the basis of direct (productive) hours worked.
- (3) On the basis of the running time of the machines, i.e. machine-hour rate.
- (4) A combination of the machine-hour rate for machine expenses and of man-hour rate for other works expenses.
- (5) On the basis of prime cost of the products.
- (6) On the basis of output of each department.
- (7) On the basis of material costs.

The auditor will have to study very carefully the method employed for the recovery of the Works' Expenses from the Cost Units in order to ascertain that it is most suitable to the needs of the business and serves to equitably distribute the whole of the expense for each period over the entire production for the same period. The main problem before him will be to see that no cost unit or job is burdened with anything more than its legitimate share of expenses.

CLASSIFICATION AND RECOVERY OF SALES AND DISTRIBUTION OVERHEAD

Where the amount of sales and distribution expense is unusually large in relation to manufacturing costs, it would become necessary not only to record the Sales Oncoſt ſeparately from the Administrative Oncoſt, but to diſſect it into appropriate ſub-heads for the purpoſe of periodical comparison and control.

Every buſineſs has its own problems as to the proper classification of Sales and Distribution Overhead, and much will depend on factors appertaining to marketing and ſales promotion efforts as alſo conditions as to delivery of goods. Generally, however, the following classification has been found to work ſatisfactorily:—

- | | |
|------------------------------|------------------------------------------------------------------------------------------------|
| 1. Sales Administration | To cover the portion of adminiſtration coſt applicable to Sales Department. |
| 2. Sales Management | To cover coſt of maintaining head and branch ſales offices and management of ſales activities. |
| 3. Sales Representation | To include travelling representatives' ſalaries, commiſſion and expenſes. |
| 4. Advertising and Publicity | To include coſt of advertising and ſales promotion efforts. |
| 5. Stock warehousing | To cover coſt of ſtorage of ſaleable ſtock. |
| 6. Packing and Diſpatch | To include coſt of packages, wrappers and packing department expenſes. |
| 7. Transport Charges | To cover coſt of delivering goods to Customers. |

The queſtion of diſtribution of Sales Overhead amongſt the various coſt units muſt alſo be conſidered in relation to the problems met with in each particular buſineſs. In general, however, any one of the following will be found to be a ſuitable method of diſtribution:—

1. A rate per each article or unit of production;
2. A percentage calculated on the ſelling price of each article or production unit; or
3. An apportionment over each coſt unit on the baſis of its factory coſt.

ALLOCATION OF ADMINISTRATIVE EXPENSE

As has already been explained, many items of expenditure being of a fluctuating character will have to be eſtimated in advance on the baſis of ſimilar expenſe in the preceding period, and will have to be brought

into account from month to month for costing purposes in order that the production of each month may be duly burdened therewith. In small businesses, where the Sales Overhead is relatively small, it is not necessary to treat it apart from the Administrative Overhead. It can, in that case, be emerged with Administrative Expense, and the total thus obtained will then be distributed over the productive departments on the basis of their respective works costs or on any other consistent and equitable basis. Where, however, the Sales Overhead is considerably large, it must be separately dealt with.

Where it is desired to deal with Administrative Expense separately from Sales and Distribution Expense, the total expense as ascertained under the former head will be allocated, in the first place, between Factory and Selling Overheads in proportions in which these departments may reasonably be deemed to have benefited by the general administration and management.

The auditor must satisfy himself as to the proper allocation and distribution of the Administrative as well as Selling Distributive Overcosts.

WORK-IN-PROGRESS

An important point that needs to be borne in mind is that while apportioning the oncost amongst production units, work-in-progress should also be made to bear its fair share of works and administrative oncosts. It should not, however, be burdened with any selling and distribution overhead as these expenses relate to marketing efforts and can be distributed over finished products only.

RECONCILIATION OF COST ACCOUNTS WITH FINANCIAL BOOKS

No system of Cost Accounting would be complete if it fails to provide means for reconciliation of Cost figures with the figures of corresponding items as disclosed by the Financial Books.

MATERIAL

The issues of direct materials to the different jobs, departments or processes would be analysed from the Stores Issue Requisitions and debited by the Costing Department to the accounts of the jobs, departments or processes concerned, weekly or monthly, as the case may be. Similarly, the direct material and stores returned, if any, would be analysed from the Stores Returned Notes and credited weekly or monthly to the accounts of the various jobs or departments concerned from the Returned Stores Analysis Sheets or Book, by the Costing Department. The total of these Direct Material Issue Abstracts or Analysis less the total of the Stores Returned Notes would serve to indicate the total value of direct material consumed and charged to the Cost Accounts during any particular period.

The Issues of Indirect Material and Stores would be evidenced by Requisition Notes of quite a different colour so as to obviate any chance of these being mixed up or taken for Direct Material Issue Requisitions. These would also be analysed weekly or monthly and would be included in the Works Oncost.

In order to facilitate comparison with the record of similar items in the financial books, two separate accounts must be maintained in the General Ledger—one for Direct Material and another for Indirect Material. All purchases of productive material would be debited to the Direct Materials Account and those of Indirect Material to the latter account. Both these accounts would be credited with returns to suppliers; if any. No entries would be made in the financial books in regard to the issues thereout. At balancing time, the stock on hand of Direct and Indirect Materials would be separately taken and valued at cost. If from the total purchases of the period *plus* the Opening Balance, if any, the closing stock is deducted, the balance would represent the value of materials consumed of each different type during the period. These figures should necessarily tally with the corresponding totals of all the Direct Material and Indirect Material Abstracts for the period as made out by the Costing Department from the Material Issue Requisitions. In actual practice, however, there will always be a small difference on account of leakages, breakages or wrong issues, but this should not exceed a certain small percentage. In this manner, a most useful and necessary check will be maintained on the direct and indirect materials dealt with.

CHARGEABLE EXPENSES

In order to maintain a check on expenses specially incurred and directly attributable to any jobs or departments, a separate Nominal Account headed "Chargeable Expenses" must be opened in the General Ledger. These expenses would be analysed weekly or monthly by the financial department and passed on to the Costing Department in order that the accounts of the Jobs or Departments concerned may be charged therewith.

DIRECT OR PRODUCTIVE WAGES

These would be independently analysed by the Costing Department weekly or monthly from the Job or Piece-Work Cards, or Productive Wages Abstracts as made out by the Wages or Accounts Department and from there, each Job Account, Department Account, Process Account or Standing Order No. will receive its respective debit in the Job Cost Ledger. The total of these Productive Wages Analysis for each week or month must tally with the total of Productive Wages for the same period as ascertained from the Financial Books.

Similarly, an abstract will be made out of Indirect Labour for the same period by the Cost Department and agreed with the total Indirect Labour.

incurred as shown by the Financial Books. The analysis of direct labour as made by the Costing Department will be with a view to ascertain how much of it is chargeable individually to the products worked during the period. The analysis of the indirect labour will be with a view to find out what wages were incurred in running the different services subsidiary to the main function of production, so that they may be included in the Works Oncost under their legitimate heads. Here, again, to serve the important purpose of reconciliation of the cost figures with their corresponding items in the Financial Books, the total amount of wages for the week or the month debited to Wages Account in the first instance will have to be subsequently analysed. The analysis, in this case, will be with a view to ascertain the wages payable under each of the following heads:—

1. Direct or Productive Wages.
2. Wages for erection or extension of Buildings.
3. Wages for erection or extension of Plant.
4. Wages for manufacture of Tools.
5. Labour in respect of repairs to Buildings.
6. Labour in respect of repairs to Plant.
7. Labour in respect of repairs to Tools.
8. Sundry Indirect Labour in respect of different services rendered.

The analysis will then be journalised, debiting each of the above accounts with their respective amounts and crediting Wages Account.

This will facilitate the comparison of the weekly or monthly amounts of the Direct and Indirect Labour as analysed by the Costing Department with the figures appearing under their corresponding heads in the Financial Books for the same period. It need hardly be mentioned that inasmuch as both the Costing Department and the Financial Department compile their necessary data from the same original records, viz., the Time Cards, the Job Cards, the Piece-Work Cards or the Foremen's Abstracts of Wages, it automatically follows that the periodical totals of the Direct Labour and Indirect Labour as ascertained by each of these Departments independently must necessarily tally.

WORKS OVERHEAD

As already explained, the Works Expenses attributable to each department or section of the factory, for the current period, would be estimated in the first instance with due regard to the amounts actually expended in the immediate preceding year, based on a normal output. These figures would be subjected to necessary adjustments in view of the intended increased or decreased output, and then distributed over the departments as already explained. Each departmental overhead would be spread over its various products complete or incomplete, by any one of the several methods of oncost

allocation, as already discussed. It must be noted, however, that these estimated figures of works oncost must be compared at periodical intervals with the amounts actually expended as disclosed by the financial books, and any variations thus brought to light by way of an over- or an under-estimate must be noted for necessary adjustments in the future costs.

OFFICE OVERHEAD OR ONCOST

For costing purposes, the selling, distribution and office administration expenses coming under the category of Office Oncost will also have to be similarly estimated on the basis of past experience and then compared at periodical intervals with the sums actually expended as shown by the financial books, to find out how far they agree or disagree, so that this information may prove most valuable for future estimate.

The comparison of the Works Oncost and the Office Oncost will be greatly facilitated, if the accounts of expenses are opened in the Financial Ledger in a manner as would enable an easy grouping of the items under either Works Expenses or Office Expenses.

Further, in order to enable intelligent and reliable comparison to be drawn at the end of each financial period between the figures used in Costing and the figures as appearing in the Financial Books, the Trading and Profit and Loss Account should be drafted on the lines as shown on the next page.

A financial statement, when prepared in the above form, will greatly facilitate a close comparison of the Prime Cost, Works Cost, Cost of Production and Total or Sales Cost of a given period with the results of the Cost Records for the corresponding period, and thus serve as a means of check and control over both the sets of books. Where the needs of the business demand it, the above statement of the financial results may be prepared quarterly, or even at shorter intervals, to find out how far the cost results for the corresponding period agree with these, and in case of any appreciable difference, to inquire into and locate the causes with a view to readjustment of future costs.

COST CONTROL ACCOUNTS

A system usually utilised to control all the expenditure chargeable to costs and provide means for reconciling all the cost figures with the financial accounts is by opening Cost Control Accounts in the General Cost Ledger and operating the same on Double-Entry Principles.^a Cost Control Accounts provide not only a basis for reconciliation with financial books, but serve as a proof that the whole of the expenditure for any said period has been accurately incorporated in the costs. They further facilitate preparation of monthly or periodical statements of profit or loss, and thus greatly help those in management to secure a firm grip on the details of the business.

MANUFACTURING, TRADING AND PROFIT AND LOSS ACCOUNT

						Rs.	Rs.
Direct Charges :							
Raw Materials, Stock 1st January 1944	..	..	..	..	..	20,000	
Purchases	..	..	..	..	..	85,000	
Carriage Inwards	..	..	..	..	..	12,000	
						1,17,000	
Less : Stock, 31st December 1944	..	..	..	..	..	15,000	
Materials Consumed	..	..	..	..	..	1,02,000	
Direct Wages	..	..	..	..	..	1,25,000	
Direct or Chargeable Expenses	..	..	..	..	..	7,500	
							Prime Cost
							2,34,500
Works Expenses :							
Works Salaries	..	..	..	..	..	25,000	
Indirect Materials	..	..	..	..	..	1,000	
Indirect Wages	..	..	..	..	..	4,500	
Factory Rent and Taxes	..	..	..	..	..	5,000	
Motive Power	..	..	..	..	..	3,500	
Factory Lighting and Heating	..	..	..	..	..	1,200	
Works Repairs	..	..	..	..	..	1,500	
Factory Insurance	..	..	..	..	..	700	
Loose Tools	..	..	..	..	..	500	
Works Stationery	..	..	..	..	..	200	
Plant and Works Depreciation	..	..	..	..	..	1,350	
Oiling and Cleaning	..	..	..	..	..	350	
Gas and Water	..	..	..	..	..	600	
Workmen's Compensation	..	..	..	..	..	1,100	
Administration Expenses-proportion	..	..	..	..	..	2,000	
							48,500
							Factory or Works Cost
							2,83,000
Administration or Office Expenses :							
Office Salaries and Wages	..	..	..	..	..	6,000	
Office Rent and Taxes	..	..	..	..	..	900	
Printing and Stationery	..	..	..	..	..	650	
Office Repairs	..	..	..	..	..	210	
Office Lighting and Insurance	..	..	..	..	..	300	
Postages and Telegrams	..	..	..	..	..	325	
Telephone Charges	..	..	..	..	..	425	
Directors' Fees	..	..	..	..	..	1,500	
Legal Expenses	..	..	..	..	..	750	
Audit Fees	..	..	..	..	..	1,000	
							12,060
							Cost of Production
							2,95,060
Selling and Distribution Expenses :							
Advertising	..	..	..	..	..	8,500	
Printing and Stationery	..	..	..	..	..	1,750	
Travellers' Salaries	..	..	..	..	..	2,500	
Travellers' Commission	..	..	..	..	..	3,700	
Showroom Expenses	..	..	..	..	..	1,150	
Bad Debts	..	..	..	..	..	700	
Postages and Sundries	..	..	..	..	..	800	
Carriage and Freight	..	..	..	..	..	1,400	
Running Expenses—Delivery Vans	..	..	..	..	..	2,200	
Depreciation—Delivery Vans	..	..	..	..	..	520	
Insurance	..	..	..	..	..	400	
Directors' Fees—Portion	..	..	..	..	..	1,000	
							24,620
Cost of Sales or Selling Cost							3,19,680
Add : Net Profit							50,320
							Total Sales = Rs. 3,70,000

PROFIT AND LOSS (RECONCILIATION) STATEMENT

Although both the Financial and Cost Accounts are written up from identical sources of information, there usually arises a difference between the profits as disclosed by the Profit and Loss Account compiled from the Financial Books and those as reflected by the Cost Accounts. As a rule, factory and other overheads are the principal causes for such disagreement inasmuch as whereas the Financial Accounts record the actual expenses incurred and paid during each period, the Cost Accounts introduce an element of estimate or approximation in this connection. There are, however, numerous other items which ordinarily find their place in the financial accounts but which are excluded from Cost Accounts, and these must also cause a difference in the net results as indicated by both the sets of accounts. A Profit and Loss (Reconciliation) Statement is, therefore, usually prepared to reconcile the difference between the two results.

The main causes of difference may be summed up as under:—

- (1) Difference between the Overhead Expenses actually incurred as shown by the financial books and those recovered from costs, the latter being taken on the basis of approximation.
- (2) Variation in method of stores and finished stock valuations between the two sets of accounts.
- (3) Variation in method of calculation of depreciation.
- (4) Items appearing in financial accounts, but excluded in Costs:—
 - (a) Capital Expenditure, if any, charged to revenue;
 - (b) Profit or Loss on sale of fixed assets;
 - (c) Exceptional losses due to removal of business, damages payable
 - at law, etc.;
 - (d) Debenture Interest, where interest is not included in costs;
 - (e) Amounts written off goodwill, preliminary expenses, brokerage on shares, underwriting commission, etc.;
 - (f) Loss due to obsolescence of machinery;
 - (g) Excessive provisions for Doubtful Debts, Discounts, etc.;
 - (h) Income-tax, if charged to revenue;
 - (i) Losses due to special circumstances such as strikes, or plant shut down due to failure of supplies of raw materials or power; and
 - (j) Credits in respect of rent or interest, or transfer fees.

The following illustration will serve to indicate the form such a Reconciliation Statement would take:—

PROFIT AND LOSS (RECONCILIATION) STATEMENT

For the three months ended

	Rs.		Rs.
To Works Overhead under recovered ..	3,120	By Net Profit as per General Cost Ledger ...	1,72,400
„ Loss due to obsolescence ..	5,700	„ Administrative Overhead recovered in excess ...	1,700
„ Income-tax ..	40,300		Rs.
„ Loss due to depreciation, in stock values ...	6,750	„ Depreciation charges in excess ...	..
„ Net Profit for the period as per financial accounts ...	1,28,755	Amount recovered in Costs ...	12,500
		Amount charged in Financial Accounts ...	11,200
			1,300
		Interest on Investment ..	8,000
		Bank Interest and Transfer Fees ..	750
		Stores adjustments ...	475
			<hr/>
	Rs. 1,84,625		Rs. 1,84,625

AUDITOR'S REPORT

Following his examination of details of the Costing System and the results as presented, the auditor should closely inquire into the method of valuation of finished goods and work-in-progress. He will then report upon the weak points as his investigation would disclose and make suggestions as to the improvements in the existing system which in his opinion would ensure greater reliability and accuracy of the records and the results obtainable therefrom. The Auditor's Report accompanying the Accounts must be logically divided into the following classifications:—

- (a) His remarks and suggestions as to the departmentalization of the productive departments and the division of the auxiliary services;
- (b) As to the methods in existence regarding checks on the incomings and outgoings of materials and the records in connection therewith;
- (c) As to the system of record of time and performance of direct labour, and the methods employed in the preparation of wages sheets and the payment of wages;
- (d) The system of record and allocation of indirect material and indirect labour consumed in connection with the running of the several auxiliary services;
- (e) The method employed for recovery of oncosts from the cost units;
- (f) How far the Financial Records can be remodelled so as to enable a closer reconciliation of the cost results; and
- (g) General remarks suggesting any improvements in the existing scheme of organisation as would result in a more efficient control over material, labour or expense.

CHAPTER XV

INVESTIGATION OF ACCOUNTS

DEFINITION

An investigation may be defined as an inquiry into the resultant profit or loss of any business for the past several years in order to ascertain the normal profit-earning capacity of the business and the necessary average working capital required in earning such profits, or with a view to ascertain the true financial condition of the business for a particular object in view.

DIFFERENCE BETWEEN AN INVESTIGATION AND AN AUDIT

An investigation would stand to differ from an audit for the following reasons:—

(1) In a majority of investigation cases, the books of account of the concern in question would already have been subjected to a regular audit.

(2) An investigation covers not only a minute and critical examination of the financial records, but it includes also an exhaustive and close survey of the varied factors and circumstances that may have led to the past success or failure of the business, or the collecting of definite data outside the books for a specific object in view. The investigator has, therefore, to look for his information far behind the books for something much more than mere figures.

(3) An audit would mean examination of the books of account for a period extending over six months or a year at the most, whereas an investigation may relate to a period sometimes even extending over five to seven years.

(4) Where any statement of earnings or the average working capital necessarily employed for such a purpose has to be presented as the result of an investigation, certain adjustments in the annual accounts already prepared and audited are always found necessary, having due regard to the object of such investigation and the nature of the business concerned.

INVESTIGATOR'S WORK AND REPORT

When a Professional Auditor is called in to make an investigation of the books of account of any concern, the first thing he should ascertain would be the object of such investigation. The scope and method of investigation would then have to be determined upon after having due regard to the nature of the business, the manner in which the books of account have been kept, the system of Internal Check and Control in force and the purpose to be achieved from such investigation.

It is highly essential for the investigator to obtain clear and concise instructions in writing from his client, specifically indicating the objects and

scope of the investigation. If any limitations are placed on the scope of his work these should particularly be placed on record, as otherwise, if anything went wrong, the investigator would be held liable for negligence in respect of work he was not asked to do. The investigator should be actuated at all times with the desire to be of real service to his client, and should therefore always act in his best interests. He should exert the utmost care, skill and diligence throughout the conduct of the investigation, and must use the greatest caution while drawing his conclusions therefrom. He must base his opinion after most carefully weighing all the points that may have arisen in course of his investigation, and never allow himself to be unduly influenced in his decision either by his client or by any other interested person.

In fact, most of the investigations would commence with the audited accounts and the auditor's reports to which the investigator will usually have access as the basis of the work, and as a result, much detailed checking which usually obtains in an audit would be eliminated on the assumption that the accuracy of the book entries would already have been substantiated by the auditor.

It is usually permissible for the investigator or his assistants to tick the entries checked or to initial the vouchers examined, but special care should be taken to see that such ticks, check-marks or initials are done as neatly as possible so as not to disfigure any record, and should be so made as to be positively and readily identified.

• Whatever the purpose or nature of the investigation may be, the investigator would do well to preserve all working papers and notes as to the inquiries made, the information obtained and the explanations received, the adjustments made and all other data bearing on the investigation, as the same may prove invaluable for reference in the future, if any question arose requiring any explanation. Any neglect of this precaution may sometimes result in unnecessary worry and duplication of work.

By far the most important part of any investigation work is the presentation to the client of the conclusions arrived at by the investigator in the form of a Report, which should be drafted with the greatest possible care and precision. This is highly essential in view of the fact that the Report following upon an investigation will be relied upon almost implicitly by the clients and possibly also by third parties, and if any misleading statements are found in it, the investigator will be held liable in damages for such misstatements.

The Report should aim at exhibiting lucidly and concisely all the important points covered by the investigation. The whole subject-matter of the Report should be properly classified and logically set forth in a language free from any ambiguity. While stating all the essential features, care should be taken not to stuff it with non-essentials. It should be free from masses of details, but may be accompanied by comparative statements and schedules,

where necessary. While reviewing the steps taken in the conduct of the investigation, the limits, if any, placed on the scope of such investigation should be particularly brought out.

Comparative statements of earnings and expenditure as also of the liquid position of the concern will afford valuable data relating to the progress of the undertaking. It should be seen whether the sales are fairly stable or are fluctuating violently, and in the latter case, the investigator must find out the reasons for such fluctuations. In fact all fluctuations in earnings must be carefully noted and explained in the Report. If the investigator finds that the sales and the profits have been showing a downward movement, he must specify this fact to his client. Any income arising from abnormal operations should be specifically stated and eliminated from the normal income.

If the period to be covered is left to the investigator, it should be borne in mind that the longer the period, the more accurately and conclusively would the trend of the business be ascertained.

Where the fixed assets have been taken as per the valuations of any expert valuer, the fact must be clearly stated in the Report.

It need hardly be mentioned that the item which is most easy of manipulation is the figure of closing stock, and this is the one item which materially controls the purchase price of the business. It should be remembered that the seller will naturally have stated his inventories at the highest possible price, and that an over-statement of the stock-in-trade must necessarily result in an over-statement of profits. Besides, the valuation of the goodwill and the inducement to acquire the business will depend entirely on the past net earnings. The investigator should, therefore, pay the greatest possible attention and bring to bear his best skill and experience on the verification of this item. If he represents a purchaser, he should make a specific mention in his report of the steps he has taken to satisfy himself as to the accuracy of this item.

Bearing in mind the fact that no business will continue to yield super-profits in perpetuity, the value of goodwill, by whatever method it is ascertained, must be based with due regard to this vital fact.

The Investigator may point out to the prospective purchaser, if the business has suffered from insufficient working capital and has thus been burdened with heavy interest on loans and inability to take full advantage of the discounts. He may even suggest how far there is scope for effecting economies in the future conduct of the business with the resultant increase in profits, provided sufficiency of capital and the volume of business are maintained. He should, however, be most careful in wording such comments so that the same may not be interpreted as his definite opinion or statement of future results.

The Investigator should not fail to secure from his client all the information which he would need for his investigation and report. It is equally essential that the Report should be drafted immediately on completion of the investigation, from the notes he may have already taken, when the details in regard to all the points are fresh in his mind. It would be highly desirable for him to discuss the various matters which he wishes to embody in his Report with his client so that he may have an opportunity to review the points from his client's view-point. The Report to be of any value should then be handed over as promptly after the completion of the work as possible.

If the Investigator does not wish to assume any responsibility for the correctness of the accounts which he has not been asked to audit, he should qualify his report accordingly by a clear statement that he has accepted the accounts presented to him for investigation as correct without any verification of the books, and will not, therefore, hold himself responsible in case there happened to be any fraud or errors lying concealed.

Lastly, the investigator's Report is supposed to furnish to his client all the information bearing on and resulting from the investigation he has carried out. He should, therefore, restrict himself mainly to facts and figures which are reliable and relevant, and should refrain from submitting any estimates of future earnings based on pure surmise. It should be definite and precise as to the final conclusions arrived at by the investigator, thus representing a well-thought-out opinion on the results of the investigation.

DIFFERENT CLASSES OF INVESTIGATIONS

The following may be mentioned as the usual circumstances which most frequently call for an investigation of accounts by a Professional Auditor:—

(1) An Investigation of Profits of a Private Concern for Prospectus purposes.

(2) An Investigation on behalf of a client who wishes to purchase a business.

(3) An Investigation on behalf of a client who wishes to become a partner in an existing firm.

(4) An Investigation on behalf of a prospective shareholder.

(5) An Investigation to ascertain the claim for compensation resulting from the compulsory removal of a business.

(6) An Investigation with a view to reorganization of the share capital of a company.

(7) An Investigation in case of a suspected fraud.

INVESTIGATION OF PROFITS OF A PRIVATE CONCERN FOR PROSPECTUS PURPOSES

The services of Professional Auditors are frequently engaged by the vendors of an established business or by the promoters of a company which proposes to acquire such a business, for the purpose of a Certificate of Profits to be embodied in a Prospectus offering Shares or Debentures to the public. On an auditor being called upon to investigate, he should first see that he receives written instructions from his employers clearly defining the purpose of the investigation and the period to be covered. He will then require copies of the Trading and Profit and Loss Accounts and Balance Sheets for the period under investigation, and a list of the books of accounts maintained by the concern. If the books have been annually balanced and the accounts are duly certified by a Professional Auditor, he should ask for the reports, if any, accompanying the audited accounts. The investigator will then carefully inquire into the special features of the business before proceeding with the work.

Where, however, the accounts have not been subjected to an audit, the investigator will have necessarily to do a sufficient portion of vouching and detailed checking to enable him to ascertain whether the books in themselves embody a correct record of all the transactions of the business, and whether the periodical accounts as prepared by the book-keeper do faithfully reflect the true resultant profit or loss of each year. There are occasions when he may find that the books have not been regularly balanced and no periodical accounts have been prepared. Under such a circumstance, he will have not only to check exhaustively the transactions already recorded, but also prepare final accounts at the end of each year. The work thus entailed would in such a case exceed the work involved in an audit.

Where the accounts have already been prepared, these will have to be re-drafted on a uniform basis, so as to serve the most useful purpose of comparison. With this object, the Trading and Profit and Loss Accounts should be written out in a columnar form, with a column provided for each year on either side. It would be equally advisable to have space along with each year's column for inserting the percentage that each item of expenditure bears to the turn-over. The Balance Sheets should also be prepared in a columnar form, in order to facilitate the comparison to be made of the various assets and liabilities from year to year. The preparation of accounts in this form will give a fund of most valuable information that would help materially in the conduct of the investigation, as the whole of the accounts relating to the period of examination would be available at a glance in a concise form.

In course of an investigation of this nature, the percentage as above said will be found very useful. They will serve to indicate how far the various expenses have increased or decreased in accordance with the turn-over. Besides, a comparison of the percentage that the gross profit of each

year bears to the turn-over will serve to throw important light on the question of whether the stock has been valued on a proper basis from year to year. Thus, if the percentage of gross profit to the turn-over in any particular year shows an abnormal increase, the same may be due to either the material or labour market having gone down and the selling price having been maintained at the same level as in the previous years, or that the selling price may have risen and the cost of material or labour may have remained constant, or it may be the result of the closing stock of that year having been brought in at an inflated value. It will thus be seen what an important part the percentages will play in indicating the true relative value of each item in the accounts.

The Trading Accounts should be closely scrutinised to ascertain whether the sales from year to year have been on the increase or decrease and whether the percentage of gross profit has been varying to any considerable extent or constant. If there has been any violent fluctuation in the percentage of gross profit, it should be ascertained that it is not the result of the stock values having been brought in at incorrect figures. It should further be seen how the closing stock of each period stood in comparison with the turnover of that period. If it is found that the closing stock throughout the period has been on the increase with no corresponding increase in sales, the question of stock valuation must be thoroughly investigated.

The Profit and Loss Account of each year should be scanned to see how far the percentage of each item of expenditure compares in its relation to the turn-over. In case of an increased turn-over, certain expenses such as travellers' commission, advertising, and organisation charges might show a corresponding increase. On the other hand, certain fixed charges such as Rent, Rates, Taxes, Office Salaries, etc., will necessarily remain constant and their percentages would show a tendency to decrease in case of an increased turnover.

The following points will call for particular scrutiny by the investigator:—

PURCHASES.—It should be seen that the purchases of each year are properly brought in that year's accounts. For this purpose, a few of the entries in the Purchase Book at the commencement of each financial year should be verified with their original invoices to see that the dates thereon agree with the dates of entry. Careful enquiry must be made to see that no goods purchased during the last few days immediately preceding the financial close of the last year are included in stock and not entered in the Purchase Book. For this purpose, the Warehouse Book or the Gate Book showing the goods actually received from day to day will have to be scrutinised for the few days prior to the date of last balancing.

SALES.—The important point to be seen in this connection would be to ascertain that only the goods actually delivered are entered in the Sales Book. The Returns Inwards Book for the period immediately following

the financial close of each year should be scrutinised to see that there are no unusually large amounts of returns entered during that period. If such returns appear to be considerably in excess of the average, it may be that such entries are made to cover the wrongly inflated sale entries made immediately preceding the close of the previous period.

It should be ascertained that goods sent on Sale or Return are not passed through the Sales Book. It should further be seen that the entries in the Sales Book are made of the net amounts after deduction of the trade discount.

Where the sales are effected through travellers or canvassers, it should be seen that the commission payable to them on the sales is duly brought into account in each period.

Careful scrutiny must be made to ascertain that the unusually large sales of the last year of investigation are not due to the concern having secured favourable contracts which are not likely to be renewed. Enquiry should also be made to see that there are no existing contracts which are being worked at a loss and which will have to be carried through by the company, for, in the event of such a circumstance existing, the point will have to be specially reported upon.

CONSIGNMENT GOODS.—Where there are unsold goods on consignment on hand, care should be taken to see that these are not valued at anything beyond the actual cost price which would of course include the expenses of transmission of the goods. Where, however, these goods have failed to realise even the cost price, they should be valued at the market price.

STOCK ON HAND.—The question of stock-taking and valuation must be most carefully examined. It should be seen that a proper system of internal check has been followed in the taking of stock, and that the stock sheets of each year are duly initialled by the persons responsible for their preparation, and are certified by authorised officials. An equally important point would be to ascertain that the stock at the end of each year has been taken on a uniform basis. All depreciated, shop-soiled, or obsolete stock should be properly written down, and under no circumstance should any stock be valued at above cost.

Care should be taken to see that no goods received on Consignment or on Sale or Return and belonging to third parties are taken as forming part of the stock.

The percentage of the gross profit earned each year on the turnover should be ascertained as already mentioned above, and the cause of any unusual variation from the normal percentage should be duly investigated.

VALUATION OF FINISHED AND PARTLY-FINISHED GOODS.—Where the stock-in-trade consists of manufactured goods, great care should be taken to see that these are valued on some very sound, conservative and consistent basis. Careful enquiry should be made into the system of Costing obtaining

in the concern and the mode of allocation of the Works and Office Oncosts. A sound basis for valuation purposes is to take the partly-finished goods at their Factory Cost.

VALUATION OF UNCOMPLETED CONTRACTS.—Particular care should be taken to ascertain how the profits on uncompleted contracts have been brought into account from year to year. In such cases, all anticipated losses and other contingencies should be fully provided for, and even then, only a part of the profits made on the completed portion should be taken credit for each year on cash basis. If any contract of an unprofitable nature is going to be transferred over to the company, it should be seen that the fact is fully brought into account at the time of the valuation of the assets taken over.

BAD AND DOUBTFUL DEBTS.—It should be seen that the amounts charged to Profit and Loss Account of each year in respect of the actual Bad Debts and the provision for Doubtful Debts and Discounts are proper.

OUTSTANDING LIABILITIES.—The question of Outstanding Liabilities in regard to expenses incurred and not paid at the end of each year should be carefully examined.

PREPAID EXPENSES.—All prepaid expenses should be duly adjusted and taken credit for at the end of each year.

REPAIRS AND RENEWALS.—It should be seen that amounts expended in shape of Repairs and Replacements are not capitalised, as this would have the effect of wrongly inflating the profits.

EXPENSES.—All the Nominal Accounts should be examined to make sure that all administrative and selling expenses properly chargeable to each year are duly brought into account and that no item of expenditure is omitted or under-stated.

ITEMS OF CAPITAL EXPENDITURE.—The investigator would do well to scrutinise most carefully all items of Capital Expenditure to see that they really represent amounts expended on acquisition of new assets or *bona fide* extensions or improvements to existing assets, and are not revenue items wrongly capitalised with a view to bolster up the profits.

INVESTIGATION OF LAST YEAR'S ACCOUNTS.—The accounts of the last year of the period of investigation will require a more detailed and exhaustive scrutiny. This would become specially important and necessary where increased profits are shown as having been made during the last year. The investigator in this case will have to make sure that such profits are genuine and do not result from the omission of purchase entries, the inclusion of fictitious sales, the valuation of closing stock at fictitiously high prices, inadequate provision for doubtful debts and depreciation, omission of outstanding liabilities or from revenue charges being wrongly capitalised.

Since the object of such an investigation would be for the auditor to ascertain the average normal profit as would be disclosed by an examination

of the Profit and Loss Accounts covering a certain period and as would be equally expected to be earned by the Limited Company to be formed, it would be necessary to adjust the Profit and Loss Account of each of the years investigated.

The following would be the usual adjustments to be made in the Profit and Loss Accounts with the result that the net Profit of each year will be increased by such amounts:—

(1) INTEREST ON PARTNERS' CAPITAL AND CURRENT ACCOUNTS.—This item will not arise in case of a company and will therefore have to be eliminated.

(2) PARTNERS' SALARIES.—Ordinarily, such a charge will not arise in case of a company, and will therefore have to be ignored.

(3) INCOME-TAX.—As a rule, this is an appropriation of profits and cannot be considered as a charge on the Profit and Loss Account for the purpose of ascertaining the true Profits made in a business.

(4) CAPITAL LOSSES.—Any loss such as that arising from the sale of Investments or any other asset will have to be treated as a Capital Loss, and will therefore have to be excluded.

(5) ITEMS OF CAPITAL EXPENDITURE.—Any item of capital expenditure which may have been written off to revenue will have to be written back.

(6) EXCEPTIONAL LOSSES.—Where any exceptional loss not resulting from the ordinary course of the business has arisen on account of costs of heavy litigation, or defalcations, or loss by fire where the assets were not fully covered by insurance, the same will have to be excluded.

(7) INTEREST ON OVERDRAFTS AND LOANS.—Interest on Overdrafts and other Loans borrowed, if any, will have to be ignored on the assumption that the company will have sufficient working capital without undergoing the necessity of borrowing moneys.

(8) DISCOUNT ON PAYMENT TO CREDITORS.—Where the concern in the past had been short of working capital and could not take the advantage of the discounts offered by the creditors due to its inability to settle the accounts within the term of credit, a reasonable amount in respect of such discount should be credited to the net profit on the assumption that the company will have sufficient working capital at its disposal and will be able to avail itself of cash discounts.

(9) OFFICE RENT.—If the Company is to acquire the trade premises, the rent that the business may have paid in the past and charged to the Profit and Loss Account will have to be eliminated.

(10) EXCESSIVE RESERVES.—Any reserve for contingencies, legal costs or for doubtful debts that might have been created in excess of the legitimate requirements will have to be written back.

(11) **EXCESSIVE DEPRECIATION.**—Any depreciation that might have been written off in excess of the recognized and necessary percentage will have to be adjusted.

(12) **LOSS FROM SPECULATION.**—Such a loss being extraneous to the usual course of the business will have to be ignored.

The following items will be adjusted with the result that the net profits as disclosed by the Profit and Loss Account will be reduced by these amounts:—

(1) **CAPITAL PROFITS.**—Profit, if any, made on the sale of Investments or any other assets, being capital profit in its nature, will have to be excluded.

(2) **INCOME FROM ASSETS NOT TRANSFERRED.**—Income arising from any assets not proposed to be transferred to the company will have to be eliminated.

(3) **EXCEPTIONAL PROFITS.**—Exceptional gains made from speculation, profits made from insurance claims or by way of compensation received for compulsory removal of business will have to be ignored.

(4) **RENT.**—Rent will have to be charged to the Profit and Loss Account, if the company does not take over the business premises.

(5) **INADEQUATE PROVISION FOR DEPRECIATION.**—If the depreciation already provided for on the fixed assets is inadequate, the difference must be duly adjusted.

(6) **PROFITS ON EXCEPTIONAL CONTRACTS.**—Any gain made on exceptional contracts under conditions not likely to recur will have to be eliminated.

(7) **SALARY OF A SKILLED EMPLOYEE.**—Where it is found that the services of a skilled person would be requisitioned to do the work that was hitherto managed by one of the partners, the salary payable to such a person will have to be brought into account.

(8) **DIRECTORS' FEES.**—These will have to be provided for, as a necessary charge in the conduct of a company's business.

(9) **INADEQUATE INSURANCE.**—Where the insurance effected in the past did not sufficiently cover the full value of the assets, a provision must be made for the excess premium payable.

The object of all the above adjustments would be to see that the Profits certified may be such as would reasonably be anticipated to be made by the company when it carries on the same business.

BALANCE SHEETS.—As has been said above, the Balance Sheets will also be prepared on a columnar basis so that the fluctuations in the values of the various assets and liabilities from year to year may be seen at a glance, and the amount of working capital necessarily required may be ascertained. The last Balance Sheet will particularly call for a most exhaustive scrutiny inasmuch as it will be on the basis of this Balance Sheet that the company will take over the existing business. It is here that the investigator should

bring into play the utmost care, caution and skill he is possessed of to find out if any assets are over-stated or liabilities omitted or under-stated in order to present a false state of affairs. As a rule, the fixed assets are taken over on the basis of an independent valuation, in which case, the investigator will have no responsibility in the matter of such valuation. Items like Book Debts, Bills Receivable and Stock-in-Trade will, however, be taken over on the basis of the last Balance Sheet and the investigator will, therefore, have to examine these assets in detail before satisfying himself as to the correctness of the values set against them.

CERTIFICATE OF PROFITS

Having completed the investigation of the accounts to his satisfaction, the investigator will now proceed to draft his Certificate of Profits. Bearing in mind the responsibility involved, the certificate should be worded in clear and unambiguous language indicating the period covered by the investigation. In regard to ordinary adjustments, they need not be specifically mentioned, but if there happen to be any adjustments of importance which have vitally affected the profits, it would be desirable to clearly specify these in the report. The profits of each year during the entire period of investigation must be shown separately. Having clearly before him the object of such an investigation, the investigator should take care not to run into giving opinions or making estimates as to future possibilities in his report. His report should contain a plain statement of facts and figures resulting from his investigations without any attempt at suppression of facts as would materially help any would-be investor in gauging the true state of affairs.

The following form of certificate would serve the purpose:-

“Having examined the Books of Accounts of Messrs. Black and White, and verified the Trading and Profit and Loss Accounts and Balance Sheets for the period of three years ending with 31st December 1938, I hereby certify that the profits of the three years after making all necessary allowances and adjustments, but without charging Partners' Salaries, Interest on Capital, and Depreciation on Fixed Assets have been ascertained by me to be as follows:—

	Rs.
For the year ended 31st December 1936 ...	32,000
For the year ended 31st December 1937 ...	24,000
For the year ended 31st December 1938 ...	22,000
	<hr/>
	Rs. 78,000

The average annual profit thus works out at Rs. 26,000.

Incorporated Accountant.”

INVESTIGATION ON BEHALF OF A CLIENT WHO WISHES TO PURCHASE A BUSINESS

When a business is about to be sold and the auditor is asked to investigate the state of affairs of that business by an intending purchaser, the investigation would proceed on practically the same lines as in the previous case. The investigator will, however, have to make enquiries into the following additional points:— .

(1) The reasons which cause the present proprietor to part with his business.

The question as to why the vendor is anxious to dispose off the business must be very carefully inquired into, more especially to ascertain whether it is due to the falling off of the business. If the vendor is retiring from the business for reasons of health or old age, it would in no way affect the value of the business.

(2) Whether the business calls for particular skill or influence.

Another important point that would need to be enquired into would be as to whether the nature of the business calls for any exceptional skill or influence, and whether such skill or influence, would now be entirely lost to the business. If the purchaser is not to enjoy the benefit of the skill or influence that hitherto obtained in the business and which is necessary to its successful working, the value of the goodwill would be considerably affected.

(3) Except in case of patented articles which would be more or less a monopolised business, the question of competition must be seriously considered.

(4) If the business relates to any fancy articles the demand for which would depend on public taste or fancy, the fact that public taste and fashion are constantly on the move should not be lost sight of.

(5) If the business is a manufacturing undertaking, it should be enquired whether the works are equipped with the latest type of plant and machinery, or whether a necessity would arise shortly to reinstate the existing plant with one more efficient and up-to-date.

(6) What assets and liabilities are being taken over, and the basis of their valuation.

The purchase price of the business will naturally depend upon the assets, goodwill and liabilities taken over and as to how these are valued. If the whole of the assets and liabilities as disclosed by the last Balance Sheet are to be taken over, all the items included therein should be most searchingly scrutinised. In this connection, the investigator would do well to enquire as to whether the fixed assets have been subjected to any independent valuation, and if so, how such valuation figures compare with the book values of the assets in question. He must carefully enquire into the rates of depreciation utilised in the past and whether they adequately provided for the

loss in value of those assets. If on enquiry, he finds that any of such assets are stated in the Balance Sheet at a higher figure than their present worth to the business as a going concern, he should not fail to report on this matter. Other assets that would call for an exhaustive scrutiny would be Stock-in-Trade and Sundry Debtors. As regards Stock-in-Trade, it should be seen that it is valued on a sound basis, as already explained. As to the item of Book Debts, care should be taken to see that ample provision is made for doubtful debts and discounts. A careful scrutiny must be made to ensure that all outstanding liabilities, including estimated and contingent liabilities, are brought into account.

(7) The basis on which the amount payable for Goodwill is to be determined.

Where the goodwill of the business is based on the past profits of the concern, the investigator will have to re-cast the Profit and Loss Accounts of the period under review to ascertain the average normal profits earned by the business in question and which profits are likely to be earned in the future, despite a change in the proprietorship. For this purpose, adjustments should have to be made in regard to exceptional gains or losses, such as profit or loss from speculation, profit or loss arising from insurance claim, profit or loss from an exceptional contract not likely to be renewed, or gain or loss arising from an action for damages. Similarly, income from assets not taken over and items of Capital Profits or Losses such as profit or loss on sale of Investments or other fixed assets will have to be eliminated.

As already explained in the previous pages, the Profit and Loss Accounts and Balance Sheets should be prepared in a columnar form so that it would greatly facilitate a comparison of the various items embodied in the accounts, and would help the investigator to obtain a fund of most valuable information by enabling him to see at a glance if there has been any violent fluctuation in any of the items. The percentage that each item bears to the turnover would also be found most serviceable.

Where the goodwill is based on the turnover, the sales of each year should receive most careful and exhaustive scrutiny.

Most careful enquiry will also have to be made by the investigator as to whether the past profits of the business were due to any special privileges, monopolies, patents or trade-marks, and whether the same benefits are likely to accrue to the purchaser.

It would be equally important to enquire into the fact as to whether the situation of the trade premises was a necessary factor in earning the past profits, and if so, whether the lease is shortly to expire or whether the purchaser is to enjoy the occupation of the same premises for reasonable length of time.

(8) Whether the vendor is to be prevented from carrying on a similar business.

Another vital factor that will materially affect the value of Goodwill would be as to whether the vendor will be allowed to continue in the same line of trade. If the vendor is going to continue in business, there should certainly be a restraint on the area within which he would be allowed to carry on the same. The vendor, in such circumstance, should be bound down not to solicit his former customers.

(9) Further special points of enquiry:—

Where the profits of the last year in particular have been on the increase, the investigator must most searchingly scrutinise the expenses to ensure that they are reasonable and that there has not been undue reduction under any of the usual heads in comparison to the figures of the preceding years, as one likely way of inflating profits is to pay a portion of business expenses out of private moneys.

It should be seen that the increased profits of the last year are not due to any drastic reduction in advertising expenses where large amounts are annually spent under this head to maintain the turnover.

Another enquiry of vital interest would be to thoroughly scrutinise the contracts in hand to ascertain that the business is not burdened with unprofitable contracts or commitments which have yet some years to run.

Where sales of large amounts are constantly made to certain customers only, it may be that the business is being patronised by a few friends of the present owner, and that such patronage may cease to continue after the sale of the business.

Finally, the investigator must see that the closing stock, specially if it happens to be a manufacturing concern, is not unduly inflated by valuation of the stock of finished goods as also goods in process with an excessive loading of oncost burden. Where the sales of the last closing period show a considerable increase, he must satisfy himself that this is not brought about by the inclusion of fictitious sales which are set right immediately at the commencement of the succeeding period by being entered as Returns Inwards.

The accounts having been investigated, the following usual adjustments will have to be made on the past profits in order to arrive at the probable normal earning capacity of the business in the future:—

DEDUCTIONS FROM THE PROFITS

(a) Capital profits, such as profits on sale of investments or other fixed assets.

(b) Exceptional profits not arising from ordinary course of the business, such as profits from purchase of bankrupt trader's stock at exceptionally low price.

(c) Income from assets not taken over.

(d) Revenue expenditure, if wrongly capitalised.

(e) Business expenses, if paid from private resources.

- (f) Insufficient reserves, if any, made in respect of doubtful debts, depreciation, etc.

ADDITIONS TO THE PROFITS

(a) Exceptional losses not resulting from business, such as costs and damages arising from any action at law, loss arising from under-insurance, or from defalcations by employees, or loss arising from speculation.

(b) Discount on purchases, where the business has suffered in the past from lack of working capital.

(c) Capital expenditure items, if wrongly charged to revenue.

(d) Capital losses, such as loss on sale of any fixed assets.

(e) Any reserve for doubtful debts or other contingencies made far in excess of the actual requirements.

It must be clearly understood that the investigator will have full and easy access to all the books, vouchers and documents bearing on the period under review, and he will be fully authorised to ask for information and explanations on any matter relating to the verification of any of the items in the accounts or the basis of valuation of any asset or liability.

Having thoroughly investigated all the facts bearing on the continuity of the business to his satisfaction, the investigator will proceed to report to his client as to the result of his investigation. The report must be worded in a clear language and must give information on all the important points that would materially help the client to come to a decision.

INVESTIGATION ON BEHALF OF A CLIENT WHO WISHES TO BECOME A PARTNER IN AN EXISTING FIRM

Where the investigation is to be carried out on behalf of a client who wishes to take a share in an existing firm, the further points to be examined by the investigator would be:—

(1) To enquire into the reasons which prompt the present proprietors to take an additional partner.

(2) Where the new partner is required to step into the place of a retiring or deceased partner, to ascertain how far the business is likely to suffer in future due to the loss of the skill, expert knowledge or influence possessed by the retiring or deceased partner, and how far such loss is likely to be made good by the incoming partner. If the new partner as also the remaining partners do not possess the requisite skill, technical knowledge or influence, the fact must necessarily affect the future profits of the business, and the value of goodwill would diminish accordingly.

(3) To ascertain whether the capital to be introduced by the intending partner is to be utilised in paying off the old liabilities, or whether it would serve as additional working capital for the expansion of business, and thus tend to increase its earning capacity.

(4) Where the capital to be brought in by the incoming partner is required to meet the present liabilities of the firm, to enquire whether the working capital left after payment of the pressing liabilities would be sufficient to meet all future demands of the business.

(5) Where the fresh capital to be introduced by the new-comer is required for the purpose of developing and extending the business, to ascertain how far the business is capable of being developed, and whether the capital asked from the new partner will be sufficient for such development and extension.

(6) To ascertain how far the capital that the incoming partner is asked to contribute compares with the capitals of the other partners in view of the profit-sharing arrangements.

(7) To determine the probable amount of profits that the intending partner would stand to get, and whether, in view of such share and all other facts, the goodwill amount he is asked to bring in is reasonable.

(8) To make sure that the business is not financially embarrassed, and that it is not sought to burden the new partner with the share of loss arising from any existing unprofitable contracts.

(9) To examine the last Balance Sheet on the basis of which the partnership is going to be arranged in order to ascertain that there are no assets shown at inflated values and no liabilities under-stated or omitted.

(10) To inspect a copy of the proposed Partnership Deed to make sure that all the usual and necessary clauses including those relating to the ascertainment of the share of each partner in case of retirement, death or dissolution are included, and that there is nothing objectionable or detrimental to the interests of the incoming partner.

(11) To frame a report embodying information on all the matters that have come to light as a result of the investigation so that the client may be enabled to come to a right decision.

INVESTIGATION OF A COMPANY'S BALANCE SHEET ON BEHALF OF A PROSPECTIVE SHAREHOLDER

We will assume that the client in question is a Prospective Shareholder who is considering the acquisition of a substantial number of Ordinary Shares in a company. The Company's audited Balance Sheet for the last year is submitted to you for the purpose of criticism, and you are asked to submit the results of your investigation. State what inquiries you would make to enable you to arrive at proper conclusions.

The Balance Sheet is as under:—

THE X. Y. Z. CO., LTD.

BALANCE SHEET

As at 31st December 1940.

	Rs.		Rs.
Share Capital:—		Goodwill at cost less written off ...	24,000
10,000 7% Preference Shares of Rs. 10 each, fully paid ..	1,00,000	Freehold and Leasehold Properties at cost less depreciation ..	2,70,000
30,000 Ordinary Shares of Rs. 10 each, fully paid ..	3,00,000	Plant, Machinery and Loose Tools at cost less depreciation ..	1,70,000
6% Mortgage Debentures ..	1,50,000	Furniture, Fixtures at cost less depreciation ..	15,000
Accrued interest on above ..	4,500	Motor Lorries at cost less depreciation ..	40,000
Trade Creditors ..	72,000		Rs.
Creditors for Loans ..	75,500	Trade Debtors ...	65,000
Outstanding Liabilities for Expenses ..	8,000	Less: Reserve for doubtful debts ...	5,000
Depreciation Fund ..	55,000		60,000
Reserve Fund ..	30,000	Sundry Advances ..	16,000
Profit and Loss Account—		Prepaid Expenses ..	2,000
Balance brought forward from previous year less dividend ..	9,000	Stock-in-Trade & Work-in-Progress at cost ..	1,45,000
Add: Net profit for the year ...	45,000	Stock of Stores & Packing Material at cost ..	45,000
	54,000	Advertising Suspense ..	6,000
Less: Preference Dividend for half year ended 30th June 1940 ...	3,500	Organization Expenses ..	12,500
	50,500	Cash at Bank & in hand ..	40,000
	8,45,500		Rs.
			8,45,500

The object of the investigation under such a circumstance will be:—

- (a) To ascertain the net intrinsic worth of the assets minus the liabilities employed in the business.
- (b) To determine the earning capacity of the undertaking, and
- (c) To find out how far such earnings could be depended upon for its continuance in the future.

This will necessitate inquiries on the following lines:—

(1) The Company's Memorandum and Articles of Association will have to be studied to determine the following:—

- (a) The voting rights of the Preference and Ordinary Shareholders.
- (b) Whether the Preference Shares are cumulative as to dividends.
- (c) Whether they are preferential as to refund of Capital.
- (d) Whether they have any extra rights to participate in the profits arising from liquidation, and
- (e) Whether the Company has the right to issue further Shares with any preferential rights as would affect the position of the existing Ordinary Shareholders.

(2) The investigator should call for his inspection the audited accounts and the auditor's reports of at least further two previous years and see if any useful information can be gleaned therefrom. This will also enable him to form an opinion as to the stability or otherwise of the enterprise in question.

(3) It should be ascertained when the Debentures become redeemable and what the terms of redemption are.

(4) It should be inquired whether the Creditors for Loans are secured or unsecured. This should have been clearly specified as required under the prescribed form of Balance Sheet. In view of the scanty liquid resources of the Company, an important inquiry will be as to the terms of repayment of these loans. If these are repayable at short notice, the Company would be hard put to in finding the necessary working capital.

(5) It should be seen that the rates applied for the depreciation of Freehold and Leasehold Properties have been adequate. A further inquiry should be made if these assets have been subjected to any recent valuation.

(6) In regard to Plant and Machinery, Loose Tools, Furniture and Motor Lorries, an inquiry should be made into the adequacy of the rates applied in writing off annual Depreciation. If the Plant has been subjected to any recent valuation, the report should be asked for. If there have been any additions to these assets, it should be seen whether they represent actual capital expenditure, or mere repairs and replacements wrongly capitalized.

(7) The basis of valuation of Stock-in-Trade and of Work-in-Progress will call for most searching scrutiny. It should particularly be seen that in valuing work-in-progress no percentage is added in respect of Office Oncost.

(8) The adequacy in respect of Provision for Doubtful Debts would be inquired into, and it should be ascertained whether all known Bad Debts have been written off.

(9) In regard to the expenditure under the heading of "Advertising Suspense" and "Organization Expenses", an inquiry would have to be made into whether the amounts expended can really be classed as extraordinary and whether the amounts carried forward really represented corresponding benefits expected to be reaped in the future.

(10) A comparison of the turnover of the past three years as also the percentages of gross profits earned on the sales will throw some valuable light on the company's workings.

(11) A similar comparison of the percentages which the office expenses bore each year to the sales will also be found to be very useful.

(12) The Profit and Loss Accounts of the last three years should be scanned to see that no items of capital gains are included; also whether any profits have arisen from any unusual contracts which are not likely to recur.

(13) Inquiries will have to be made if there are any actions at law pending against the company, whether there are any disputed claims, whether

the company has stood guarantee in respect of any debts, and whether there are any likely losses on contracts undertaken by the company and not so far brought into account.

(14) If on inquiry, it is ascertained that any asset appears at a value far in excess of its worth to the business as a going concern, or if any liability is omitted or under-stated, an adjustment in this behalf would become necessary.

(15) The value of goodwill cannot be taken at the figure at which the item appears in the Balance Sheet, but will have to be ascertained on the strength of the earning capacity of the business as also several other factors that will have to be considered. It will not, therefore, be considered as a tangible asset for the purpose of finding out the effective capital employed in the business.

In regard to Goodwill, the following considerations would seem to be necessary. Taking the last year's profits of Rs. 45,000 as a fair guide towards the anticipated earnings in the future, and assuming that a look at the previous two or three year's Profit and Loss Account justifies the hope, it would now become necessary to find out the amount of capital usefully employed in earning such income, with a view to ascertain the percentage of net profits on the effective capital. The same would be ascertained as under.

(16) Assuming then that an exhaustive inquiry into all the above points having been made and the auditor having been satisfied with the correctness of the valuations placed against the several assets and liabilities as shown in the Balance Sheet (with the exception of Advertising Suspense and Organization Expenses which are deemed to be worth not more than Rs. 3,000 each), the following will be the procedure:—

	Rs.	Rs.
Total Sundry Assets as per Balance Sheet		8,45,500
Less Goodwill	24,000	
„ Advertising Suspense	3,000	
„ Organization Expense	3,000	
„ Depreciation	55,000	
		<hr/> 85,000

Total Tangible Assets = Rs. 7,60,500

Less Trade Liabilities:—	
Trade Creditors	72,000
Creditors for Loans	75,500
Debentures	1,50,000
Creditors for Expenses	8,000
Interest for Loans	4,500
	<hr/> 3,10,000

Effective capital employed in the business = Rs. 4,50,500

The Net Profit of Rs. 45,000, therefore, works out practically at 10 per cent on the tangible capital employed.

If we assume that the normal yield in this particular class of industry is 10 per cent in view of the risks involved, there can hardly be said to be any value attached to goodwill in this business.

Apart, however, from the book figures, there will be several other points that will have to be inquired into in order to enable the investigator to arrive at a fair opinion as to the position of the company:—

(a) If the shares are quoted in the market, their present market values should be ascertained.

(b) In view of the existing Debenture and other loans, the company's Articles should be consulted to ascertain how far there are any restrictions on the company's borrowing powers.

(c) An inquiry should further be made as to what chances there would be of securing fresh loans when the Debentures and other loans become repayable.

(d) The nature of the business would also give some indication as to the stability or otherwise of the business. It should be seen whether the articles manufactured represent necessities of life or such as cater for fancy tastes.

(e) It should also be inquired, whether the successful working of the business depends on the skill of any particular individuals, and, if so, whether the company is likely to benefit from their services for a reasonable length of time.

(f) The question of the company's tenancy under the Leasehold, option for renewal, and liability for dilapidations should call for inquiry.

(g) A valuable form of inquiry would be into the age of the existing Plant, and whether there is any likelihood of its becoming obsolete in the near future and a necessity would arise to instal an up-to-date equipment to successfully meet competition.

(h) Whether there exist any heavy liabilities under contracts in force, and which are not disclosed in the accounts.

(i) Whether the business relates to a monopolised trade, or how far there are chances of its successful working sustaining any set-back due to competition.

As a result of all the above inquiries, the investigator would be enabled to form an opinion as to how far the market quotation or the amount asked for the Ordinary Shares is fair and reasonable. His opinion will be embodied in form of a Report which must clearly set out his findings, after fully discussing all the steps he has taken and the inquiries he has made to enable him to arrive at a decision.

It should be made clear at this stage that the above is a mere skeleton outline indicating in broad terms the steps an investigator should ordinarily take to enable him to judge of the advisability or otherwise of investing in shares of a company, as so much would depend upon the nature of the company's business and all the other varied facts and particulars surrounding it.

INVESTIGATION TO ASCERTAIN THE CLAIM FOR COMPENSATION IN RESPECT OF LOSS ARISING THROUGH COMPULSORY REMOVAL OF BUSINESS

Where a business is compulsorily removed due to acquisition of the property by a public body such as Municipal Corporation, Improvement Trust, Port Trust, or a Railway Company, or an Electric Power Concern, the Professional Accountant may be called in to ascertain the claim for compensation that would naturally arise due to the trade disturbance consequent upon the removal of the business. In such a case, the services of the accountant may be engaged by either of the parties, and the important point to be borne in mind is that whereas, on the one hand, the proprietor of the business would naturally be induced to show his profits as large as possible in order to secure for himself a larger amount of compensation, the party acquiring the business premises would, on the other hand, try to tone down such profits as low as possible in order that a small amount of compensation may be paid.

Such a claim for compensation would necessarily consist of the following items, viz.:—

- (1) The expenses actually incurred on account of the removal.
- (2) Actual loss suffered on account of the compulsory sale of stock and fixtures.
- (3) The loss arising from the forfeiture of the lease.
- (4) The loss that will naturally have to be suffered on account of the business being shifted to a new locality.

There will be no difficulty in ascertaining the actual expenses of removal, as these would be verified with the corresponding vouchers.

The loss arising from the sale of stock would be represented by the difference between the value of such stock ascertained on the usual basis before the date of the compulsory sale, and the amount actually realised from sale. As to fixtures, the amount of loss would be represented by the difference between the book value thereof and the amount realised.

The loss on the forfeiture of the lease will be indicated by the then existing book value of the lease plus an additional 10 to 15 per cent.

In order to ascertain the loss arising from the disturbance in trade due to the compulsory shifting of the business, it would be necessary to examine the accounts for the past three to five years in order to arrive at the average

net annual profits earned by the business in the past. The claim for compensation under this head is generally based on the average net profits for a period of two to five years according to the nature of the business and other circumstances.

The investigator's report, in this connection must clearly indicate the amount claimed under each of the above heads, and the total claim put forward together with the lines on which the investigation has been conducted.

INVESTIGATION INTO THE AFFAIRS OF A COMPANY WITH A VIEW TO REORGANIZATION OF ITS SHARE CAPITAL

Auditors are often invited by the Board to investigate into the affairs of their company which has got into a bad financial state due to past losses, and formulate a scheme for the reorganization of its share capital with a view to place its finance on a more economical and efficient basis. In such a case, the auditor will have to most critically study the financial position of the company coupled with its present earning capacity, and after carefully considering what likelihood there is of similar conditions being maintained in the future, suggest a scheme for the reorganization of its capital and other financial resources as would most equitably adjust the rights and interests of the different classes of shareholders and the debenture-holders, in shape of a Report. The case in view can best be illustrated by means of an example.

The Directors of the Swadeshi Enterprise, Limited, place before you the following Balance Sheet:—

THE SWADESHI ENTERPRISE, LIMITED

BALANCE SHEET

As at 31st December 1940.

	Rs.	Rs.		Rs.	Rs.
Share Capital:—			Goodwill at Cost		80,000
2,500 7% Cumulative Preference Shares of Rs. 100 each ...	2,50,000		Land and Buildings at Cost ...	3,50,000	
10,000 Ordinary Shares of Rs. 100 each ...	0,00,000		Less Depreciation ...	25,000	
		12,50,000			3,25,000
6% Mortgage Debentures ...		3,00,000	Plant and Machinery at Cost ...	6,70,000	
Sundry Creditors ...		2,23,000	Less Depreciation ...	90,000	
Bank Overdraft (holding a floating charge on Stock and Book Debts) ...		50,000			5,80,000
			Furniture and Fixtures at Cost ...	15,000	
			Less Depreciation ...	2,500	
					12,500
			Stock-in-trade		20,000
			Sundry Debtors		2,45,000
			Bills Receivable		30,000
			Cash at Office		5,500
			Profit and Loss Account	6,25,000	
			Less Net Profit during the year	1,00,000	
					5,25,000
	Rs.	18,23,000		Rs.	18,23,000

Further information supplied by the Directors is as follows:—

The Cumulative Preference Shares are preferential as to capital, and the dividends on these shares have been in arrears since the last five years. The company has been working at a loss ever since its inception, excepting for the last two years 1939 and 1940, when the working results showed a net profit of Rs. 80,000 and Rs. 1,00,000 respectively. The past heavy losses have seriously depleted the company's share capital, and a scheme for reduction of capital and reorganization of its finance are in view.

The directors are fully confident that the company has ceased to make losses, and with the profitable contracts in hand and their products having gained a sure footing in the market, the profits now made will easily be maintained in the future. This is provided the company is taken out of its present financial embarrassment and some working capital is forthcoming.

The mortgage debentures will shortly become repayable, but the Debenture-holders are agreeable to take up a fresh issue for a further term of ten years, provided they are offered some better terms in the matter of interest, and a definite scheme for provision in respect of Redemption of Debentures is included in the terms of issue.

The Directors have had the Fixed Assets of the company revalued in order to find out how far their present values as a going concern compare with their book values, and have ascertained that Land and Buildings need to be further depreciated by Rs. 50,000, and Plant and Machinery Rs. 2,00,000. A review of the Book Debts necessitate a further provision of Rs. 45,000 in respect of Doubtful Debts.

In the light of the above facts, you are invited to offer suggestions as to how best to extricate the company from its present financial difficulties and most satisfactorily adjust the interests of the Debenture-holders and the Preference and Ordinary Shareholders. Your recommendations are required to be in the form of a Report.

Report to the Board of Directors

GENTLEMEN,

As desired by yourselves, we have most critically examined the last Balance Sheet of your Company with a view to ascertain what scheme for the reduction of Capital can be formulated as would satisfy the Debenture-holders and most equitably adjust the rights of the Preference and Ordinary Shareholders *inter se*.

It is evident on the face of the Balance Sheet that continuous heavy losses made by your Company in the past have seriously depleted its financial resources and have thus brought about its weak liquid position. Taking the Floating Assets inclusive of Stock-in-Trade, Book Debts, Bills Receivable and Cash, their book value amounts to Rs. 3,00,500, and deducting therefrom Rs. 45,000 for Doubtful Debts Reserve, there will remain a balance of

Rs. 2,55,500 representing their estimated realisable value. As against this, the floating liabilities consisting of Sundry Creditors and the Bank Overdraft amount to Rs. 2,73,000. Besides, the Debentures worth Rs. 3,00,000 will shortly become repayable. Even assuming that the new terms as would be suggested to the Debenture-holders would satisfy them and there would then be no need for any immediate repayment of Debentures, it is clear that the company must have some floating cash available at least to enable it to tide over its present financial difficulty.

The details set out below serve to indicate how the company stands to have lost a major portion of its capital. In view of the present critical financial condition of the business, we very much doubt if there is any present value for Goodwill and whether any benefit would accrue by allowing it to remain on the Balance Sheet. Under the circumstance, we propose that it be entirely wiped off from the Books. Besides, the Fixed Assets, which appear to have been considerably under-depreciated in the past, need to be written down by Rs. 2,50,000 so as to bring their book value on a par with their present value as ascertained by the Board on a re-valuation. The total amount to the extent to which it is necessary to reduce the share capital, therefore, works out at Rs. 9,00,000, thus:—

	Rs.
For wiping off Debit Balance on Profit and Loss Account	5,25,000
For writing down Land and Buildings	50,000
• For writing down Plant and Machinery	2,00,000
For making a Reserve for Doubtful Debts	45,000
For wiping off Goodwill	80,000
	Rs. 9,00,000

The above loss of capital must necessarily affect the Ordinary Shareholders in the first instance inasmuch as the Preference Shareholders are preferential as to Capital. Evidently, therefore, it is the Ordinary Shareholders who must bear the brunt of this loss. The important point that would thus need to be stressed before the Ordinary Shareholders is that, in the present circumstance, if the Company went into liquidation, they would stand to lose their all in view of the following facts:—

- (a) That the Fixed Assets are mortgaged to the Debenture-holders;
- (b) That the Bankers hold a floating charge on the Stock-in-Trade and Book Debts to cover the overdraft;
- (c) That there are Trade Creditors amounting to Rs. 2,23,000 to be satisfied in full after the Debenture-holders are paid out;
- (d) That the Preference Shares are preferential also as to Capital; and

(e) That in case of a forced sale on a winding-up, the assets will have to be sold out at considerable sacrifice, and after satisfying all the liabilities, there will hardly be sufficient cash left to refund the Preference Share Capital in full.

On the other hand, the worst appears to have been over, and now that the company has ceased to make losses, the existing contracts having been secured on profitable terms, and with the legitimate expectations of equally profitable conditions being maintained in the future, there is no reason why the company be wound up, if the Debenture-holders can be persuaded to accept fresh Debentures in place of those shortly becoming repayable, and if the Ordinary as well as the Preference Shareholders come forward to help towards the reorganization which the Board seems to have in view.

If the existing Debenture-holders can be satisfied by the offer of a fresh issue of Mortgage Debentures of a similar amount repayable at the end of 10 years and carrying interest at the rate of $7\frac{1}{2}\%$ in place of the present 6%, a solution would be found so far as this loan is concerned, and there will then be no need to find immediate cash for the repayment of the Debentures that will soon expire. Further, there can be no objection to the company binding itself under a Trust Deed to provide for the Redemption of Debentures by setting aside annually out of profits such a sum which by being invested in gilt-edged securities would accumulate at the end of 10 years, with compound interest, to the amount necessary to pay off the Debentures. The amount to be set aside in this respect should be a first charge on the net profits prior to distribution of any dividends, and, if need be, necessary alterations to this effect will have to be made in the Company's Articles.

Inasmuch as the reorganization scheme should include, as one of its terms, some provision for fresh capital, we suggest the following for your consideration. The Ordinary Share Capital consisting of 10,000 Ordinary Shares of Rs. 100 each fully paid, be reduced to an equal number of Ordinary Shares of the face value of Rs. 20 each with Rs. 10 paid up. A call of Rs. 10 should then be made on the Ordinary Shares, and this will bring in Rs. 1,00,000 as additional working capital, which will help considerably towards averting a crisis.

The Preference Shareholders can help towards this scheme by agreeing to forego the arrears of their accumulated dividends amounting in all to Rs. 93,750, and in return for this sacrifice on their part, the Preference Shares can be made to carry a future Cumulative Preferential Dividend of 8% in place of the present 7%.

Assuming that the company maintains a minimum annual net profit in the future at Rs. 1,00,000, about which the Board is so very confident, the following appropriations can be made thereout:—

	Rs.
Amount that would be consumed by additional interest to	
Debenture-holders	4,500
Transfer to Debenture Redemption Fund	25,000
8% Dividend on Preference Shares	20,000
10% Dividend on Ordinary Shares	20,000
Amount available for transfer to Reserve Fund, etc.	30,500
	Rs. 1,00,000

The appropriation of the profits from year to year as above suggested is sure to satisfy the Debenture-holders as also the Shareholders, and the entire scheme as proposed herein should work to the equal benefit of all concerned. At the same time, there would be a Reserve Fund built up out of the surplus profits which would leave further working capital so necessarily required by the business, and would equally help the company to meet any unforeseen contingencies that may arise in the future. It may be pointed out that the Reserve Fund may or may not be invested in gilt-edged securities having due regard to the liquid resources of the company from time to time.

On the Scheme as suggested by us being carried through, and on the additional capital being called up and received, the Balance Sheet of the Company would appear as under:—

THE SWADESHI ENTERPRISE, LIMITED
BALANCE SHEET

(After the reconstruction scheme is carried out.)

	Rs.	Rs.		Rs.	Rs.
Share Capital:—			Land and Buildings at		
2,500 8% Cumulative			Cost	3,50,000	
Preference Shares			Less Depreciation	75,000	
of Rs. 100 each ...	2,50,000				2,75,000
10,000 Ordinary			Plant and Machinery		
Shares of Rs. 100			at Cost	6,70,000	
each fully paid			Less Depreciation	2,90,000	
reduced to 10,000					3,80,000
Ordinary Shares of			Furniture and Fixtures		
Rs. 20 each fully			at Cost	15,000	
paid ...	2,00,000		Less Depreciation	2,500	
		4,50,000			12,500
			Stock-in-Trade		20,000
7½% Mortgage Debentures		3,00,000	Sundry Debtors	2,45,000	
			Less Reserve for		
Sundry Creditors ...		2,23,000	Doubtful Debts	45,000	
					2,00,000
			Bills Receivable		30,000
			Cash at Bank	50,000	
			" at Office	5,500	
					55,500
	Rs.	9,73,000		Rs.	9,73,000

It would seem that under this scheme the Ordinary Shareholders, apart from being burdened with the whole loss of Rs. 9,00,000 by the reduction of their capital, are also made to contribute the additional capital required to find immediate working funds for the Company, and that the Preference Shareholders have hardly sacrificed anything. But the fact that the Preference Shares are preferential both as to dividend and capital, and in case the company went into liquidation, they would stand to get refund of their capital in full in priority to the Ordinary Shareholders for whom there would then hardly anything be left should not be lost sight of. Besides, the Preference Shareholders have agreed to forego their right to five years' accumulated Dividend and have thus evinced their desire to help towards any scheme for the reorganization of the Company's finance. It need also be remembered that, in the absence of any scheme being set on foot, the Ordinary Shareholders are not likely to receive any dividend for some years to come till all the arrears of preferential dividends were paid up, whereas in view of the arrangement as suggested, they would stand to receive a dividend of at least 10% in the immediate future, and with the liquid position of the company being strengthened from the amounts to be carried to reserve from year to year, a higher rate of dividend would be rendered available to them. This will be, of course, provided the present profit-earning conditions are maintained.

Under these circumstances, we are of opinion, that if the recommendations as set out above are carried out in their entirety, the interests of both the classes of shareholders would be most equitably adjusted.

We remain, Dear Sirs,
Yours faithfully,

INVESTIGATION IN CASE OF A SUSPECTED FRAUD

Where an accountant is instructed to investigate the books of accounts of a business in case of a suspected fraud, he should exercise the greatest skill and care in the conduct of such investigation. He should first enquire into the nature of the fraud suspected and as to who is suspected of having perpetrated the same. A point of the utmost importance for the investigator would be to examine the system of internal check in use in the concern with a view to find out whether such a system provided for a proper control over the handling of cash receipts and payments and the incomings and outgoings of goods. He should most carefully enquire to ascertain whether the cashier has access to any books of prime entry or Ledgers, and what openings there are for the cashier to cover up the fraud by fictitious entries. It is by a careful examination of the office routine and organisation that he will be enabled to trace the weak parts of the system so that particular care and attention may be devoted to that portion of the work. Having ascertained the peculiar nature of the business and the direction in which irregularities

are likely to occur, the investigator should plan his method of procedure. The method of conducting such an investigation will have to depend on the character of the fraud and the special circumstances surrounding each case, and the investigator must bring considerable tact, experience and judgment to bear on the work he is asked to perform.

Cases of defalcations or misappropriations of cash or goods vary so much in accordance with the nature of the business and the opportunities open to the employees, that it is not possible to prescribe any particular method of procedure equally suitable in all cases for the detection of any such irregularities. Experience has shown, however, that such defalcations arise mainly from want of any effective system of internal check more particularly in a business where an old and trusted employee is left in entire charge of accounting as well as finance.

DIFFERENT FORMS OF FRAUD

It is practically impossible to mention all the varied forms of fraud which human ingenuity has devised or is likely to devise under the opportunities open to those handling cash or goods, but the following are the more usual ones which a businessman often comes across, and which a professional auditor is usually called upon to investigate and report upon. Where any such fraud, however, is perpetrated by a trusted servant, it is likely to be most skilfully planned and cleverly concealed, and the detection thereof will call for the investigator's highest skill, tact and caution.

Misappropriation may result either from failure to account for cash receipts, or from entering false disbursements, or from pilferings of goods. The following list will serve to indicate the common types of fraud perpetrated by employees:—

(1) Pilfering cash from Cash Box, which will result in shortage of Cash Balance.

(2) Omitting to record some of the Cash Sales in whole or in part.

(3) Not accounting for Receipts from miscellaneous income, such as unclaimed wages, sales of scrap, sale of discarded assets, rent from sub-letting, etc.

(4) Not recording some of the Credit Sales.

(5) Not entering up return of the goods from a customer, and then misappropriating the cash realised from the subsequent sale of the same.

(6) Entering a credit sale, but off-setting the debit to the customer's account by a charge to discount, allowance or bad debt, or by even a false Returns Inwards entry.

(7) Covering the debit on a customer's account by transfer to another personal account, either that of a customer or a supplier.

(8) Covering the debit on a customer's account by a credit in respect of cash received direct into the Ledger, unsupported by any entry in the Cash Book.

(9) Where recoveries from debtors are systematically misappropriated, it is usual for the defrauding party to cover up such defalcations by placing the subsequent realisations from other debtors to the credit of those personal accounts that had paid previously. This process is followed continuously in order that the customers' accounts may not appear to have been long outstanding.

(10) Recording fictitious payments.

(11) Issuing cheques and not recording the same.

(12) Recording on the counterfoil of the cheque book less amount than for what the cheque was issued.

(13) Recording in the counterfoil of the cheque book a different name from the actual payee.

(14) Entering a payment as of a larger sum than that actually made.

(15) Entering up a fictitious purchase, and then off-setting the wrong credit on personal account by recording a false payment.

(16) Making excessive payments to suppliers by getting unjustifiable charges approved, or altering the figures in Invoices or Statements after approval. Such a fraud is usually perpetrated in collusion with the suppliers.

(17) Wrongful manipulation in wages sheets by inclusion of dummy names, or by showing excessive wages as earned. This is usually done in collusion with other employees.

(18) Irregularities in petty payments by entering fictitious payments, or altering the amounts of some of the vouchers, or by using vouchers a second time.

(19) Pilferings of goods from the stock.

(20) Fictitious sales to parties who are in collusion with the defrauder.

Fraud is also perpetrated by those enjoying higher positions, in order to secure for themselves larger amounts of commission or an increase in salary, or sometimes by the owners themselves when they have either the borrowing of a loan or the sale of their business in view. Such frauds, of course, will not result in any embezzlement or misappropriation of cash or goods, but would more vitally misrepresent the true position by serving to indicate more profitable working results or by presenting a better financial condition of the business than would be justified by the actual state of affairs. The following are the usual methods employed to deliberately bolster up the position of the undertaking:—

(1) Entering of fictitious sales.

(2) Omitting to record some of the Invoices, though the corresponding goods have been taken in stock.

(3) Over-statement of assets by not making adequate provision in respect of doubtful debts, or depreciation.

- (4) Over-statement of stock by valuing the same above cost price.
- (5) Inclusion of obsolete and unsaleable stock at cost price.
- (6) Inclusion of inflated quantities in the stock inventories.
- (7) Under-stating or omitting liabilities.
- (8) Wrongly extending advertising or organization expenses as deferred charges, beyond their legitimate period of usefulness.
- (9) Fictitiously capitalizing revenue expenditure by debiting repairs and replacements to the asset accounts concerned.
- (10) Fictitious increase in sale prices shortly before the last closing date.
- (11) Charging some of the legitimate business expenses to the proprietor's personal account with a view to bring about decrease in expenses.
- (12) Suppressing outstanding liabilities for expenses from record, and abstaining from mentioning Contingent Liabilities.
- (13) Suppressing heavy losses on forward contracts.
- (14) Bringing into account profits on incomplete contracts on wrong and unjustifiable basis.
- (15) Entering sales for future delivery in the Sales Book.
- (16) Omitting to make adjustments in respect of Closing Stocks at Branches, where these are invoiced by the Head Office at selling price.
- (17) Including Inward Consignment Stock into the Closing Stock.
- (18) Omitting to make adjustments in respect of Closing Stocks of Outward Consignments where these have been invoiced at above cost.

PROCEDURE WHERE CASH DEFALCATIONS ARE SUSPECTED

For the purpose of an illustration, assuming that cash defalcations are suspected, and an accountant is employed to investigate and report on the same, the following will be the general outline of procedure:—

- (1) The investigator must fully acquaint himself with the nature of the business, and must secure a complete list of the books of account maintained.
- (2) Full enquiries will have to be made to ascertain the extent of internal check in regard to cash receipts and payments, if any in use, and the respective duties of the employees, in order to find out what opportunities they had for misappropriations.
- (3) It should particularly be ascertained whether those in control of the books had anything to do with the handling of cash or goods.
- (4) The extent of control on purchases and sales of goods, as also whether proper stock accounts were maintained should also be ascertained.
- (5) The system of recording of Cash Sales must be thoroughly examined, and the receipts as shown by the Cash Memos must be carefully checked into the Cash Sales Summary, and from thence into the Cash Book.

(6) Any Cash Memos missing or any alterations on the Cash Memos must be closely scrutinised and proper explanations must be asked for.

(7) The whole of the Cash Book should be vouched and cast in detail and the postings checked, in the absence of any internal check.

(8) The Bank transactions should be checked with the Bank Pass Books, the bank balances should be reconciled, and certificates as to closing balances should be obtained from the banks.

(9) Receipts from the Debtors should be vouched from the counterfoil receipt books into the Cash Book and from thence to the credit of the customers' accounts.

(10) It should be seen that the regulations in regard to the proper use of counterfoil receipt books have been rigidly carried out.

(11) Any alterations on the counterfoil, either of the name or the amount should be duly authorised.

(12) Any unusual discount or allowance must be enquired into, and all amounts written off as bad debts must be duly authenticated. Very often, in order to prevent debtors' balances from appearing as outstanding, the accounts are credited with fictitious items of discounts, allowances or bad debts.

(13) Careful enquiries must be made to ascertain how far are there any chances of sales not being brought into record. Some sales might have been purposely omitted from being recorded in the Sales Journal in order that the moneys subsequently received may be misappropriated without necessitating in any way the further falsification of books. If there is any suspicion on this head, each original order must be traced into its corresponding Outward Invoice to see that its execution has been duly brought into record.

(14) All Returns Inwards should be checked into the Stock Book to ensure that they represent actual receipt of goods returned, and are not false credits given to Customers' Accounts in order to cover up the sales moneys misappropriated.

(15) It should be seen that all purchases have been duly authorised.

(16) All Purchase Invoices should be vouched with the entries in Purchase Journal to ascertain that no Invoice is entered twice. Duplicates should be obtained where any original Invoice is missing. It should be ascertained as to who passes creditors' statements for payments.

(17) Statements from the Creditors should be compared with their corresponding accounts in the Creditors' Ledger to ascertain that the closing balances tally.

(18) Similarly, the client must be asked to submit a statement to each customer indicating the balance owing by him with a request to inform the investigator directly in case of any discrepancy.

(19) All transfers from one personal account to another must be properly authenticated.

(20) All entries for Returns Inwards and Outwards must be supported by proper Credit and Debit Notes.

(21) All Cash Payments must be vouched, and duplicates of all missing vouchers should be asked for.

(22) All erasures and alterations of figures should receive most searching scrutiny.

(23) The payments in respect of salaries and wages should be exhaustively verified to ascertain that they are *bona fide*, and are duly authenticated.

(24) Any increase in salaries or piece-work rate must be duly authorised.

(25) Where Inward Consignment Goods are also dealt in, it should be seen that these are not mixed up with the Sales proper, and such goods are not included in stock.

(26) The Petty Cash Book must also be vouched, if need be.

(27) The postings of all the subsidiary records having been checked and the additions of the original records as also of the Ledger Accounts, having been cast, the investigator would do well to agree the Trial Balance, where there is entire absence of internal check.

(28) Pilferings in stock would be difficult to detect unless Stores Accounts have been maintained.

(29) Full notes should be made of all irregularities discovered and where slightest suspicion is aroused, the transaction should be traced to the end.

(30) The investigation having been completed, the investigator will report on the defalcations he has been able to discover, and such report must necessarily set out the existing conditions which presented opportunities for fraud, and indicate the lines on which some suitable internal organization may be framed so as to prevent any recurrence of similar misappropriations.

GOODWILL

As the services of professional accountants are more and more in demand in these days in the matter of investigation relating to the purchase or sale of established businesses, and as they are often called upon by their clients to ascertain the fair value of goodwill appertaining thereto, the following few remarks on the several points relating to goodwill that would require close and careful scrutiny at their hands will be found helpful.

FACTORS DETERMINING THE VALUE OF GOODWILL

The various factors which enter into a computation of goodwill may now be considered briefly.

CAPITAL REQUIRED.—The average *normal* net earning of a business over a period of years having been determined, the average amount of capital necessarily required for the purpose of earning such profits will have to be ascertained. A highly profitable concern that can be run with a small amount of capital will naturally find many purchasers and will consequently realise a decent amount of goodwill; but it would be difficult to sell a business, however profitable, that would require a large amount of capital to work, as few persons would be found willing to risk a large sum in any one business. Thus, taking two separate businesses yielding an equal percentage of profit, the one requiring less capital will be more in demand and will realise a higher amount for goodwill.

NATURE OF BUSINESS.—The nature and class of the business is an important factor. It must be looked to whether the articles dealt in are the daily necessities of life, or whether the business is dependent on popular taste, fashion or public fancy; for, if the latter, it is often likely that the profits will diminish once the public fancy dies out. Or, it may be that the business in a particular article may be ousted by a new and more attractive product appearing in the market.

RISKS INVOLVED.—It must be enquired to what extent the business is open to risks, for the greater the risks involved, the higher the percentage of return on capital the purchaser must expect. Further, if the business happens to be of a very risky or speculative character, its goodwill will have very little value, as few persons will be found prepared to risk the loss of capital.

SKILL IN MANAGEMENT.—It may be that the business calls for exceptional skill and ability for its success, and that such skill was provided in the past by the former owner of the business. If such be the case, the purchaser must make sure whether the services of the owner will still continue to be enjoyed by the concern in the future. It goes without saying that the value of goodwill will be considerably enhanced, if the vendor agrees to continue his connections with the business for some time after the sale and thus give the new proprietor the benefit of his skill, experience and influence.

If the cost of such skilled supervision was not formerly charged against profits due to such services having been rendered by the former proprietor, now that the business is being disposed of and that such services will have to be paid for, a provision will have to be made in regard to the estimated cost of such management in order to arrive at a fair estimate of the profits likely to be earned in the future. It must be noted, however, that a business which calls for much personal skill and supervision for producing a certain income will be less in demand than a business yielding similar income without such skill in management, and its goodwill value will therefore shrink in proportion.

ESTABLISHED LOCATION.—Location of the business sometimes counts for more than all the other factors put together. This would specially happen in case of an established shop or large stores located in a prominent position. In such a case, location will form a very vital question in assessing its goodwill. If the premises are held under a long lease, the purchaser would undoubtedly reap the benefit of past connections, as the old customers would naturally resort to the old place. If, however, the leasehold in which the business had so far been carried on is likely to expire shortly, the purchaser must enquire whether a renewal would be obtainable on reasonable terms, for if he fails to secure a renewal of the lease or some other equally suitable place in close vicinity, the removal of the business to some other locality would mean loss of old connections, and goodwill will suffer in value accordingly.

FUTURE COMPETITION.—The possibility of future competition is another factor to be carefully considered, for if there is any likelihood of the vendors competing with the purchaser, goodwill will diminish in value. It is always necessary in the interest of the purchaser to see that the agreement for the sale of goodwill to him contains a clear declaration that the vendor is restrained from setting himself up in the same class of business. The more restrictive such an agreement is, the more valuable the goodwill of the business will be to the purchaser.

MONOPOLISED BUSINESS.—If the past success is due to any trade monopoly, it should be enquired whether the benefit of such monopoly is likely to continue. It should further be seen whether the patents hitherto enjoyed are expiring, or whether the success of the business is likely to be affected in the near future by new inventions or by new rivals setting up in the same line or trade.

TRADE NAME.—Sometimes, the goods dealt in may have a world-wide reputation and may be recognised everywhere by a trade name or a trade mark. Under such a circumstance, the right to use such a trade name or trade mark will be a valuable factor in assessing goodwill.

PROFITS FROM EXCEPTIONAL CONTRACTS.—If during the period of years on the profits of which the goodwill is based, there appear to be exceptionally profitable contracts or other special circumstances which have helped in producing results which are not likely to recur, such profits will have to be eliminated for the purpose of arriving at the average normal yield from the business.

PENDING CONTRACTS.—If there are pending orders or contracts of a recurring nature likely to result in substantial profits, these will necessarily enhance the value of goodwill.

PERSONAL BUSINESS.—The goodwill of a purely personal business such as that of a solicitor or a doctor is always of a doubtful value, unless the conti-

nued co-operation of the person who built up the business is secured for say at least 2 to 3 years after the sale of the business.

DECLINING PROFITS.—A business might have shown good resulting profits during the last several years, but if such profits have been on the decline from year to year, its goodwill, if at all there be any, will have to be valued on a very conservative basis. In any case, the cause of such decline must be traced to see if the defect can be remedied.

OLD MACHINERY AND ONEROUS LEASEHOLD.—If the assets of the business, to be acquired consist of very costly machinery, it should be seen that the same is not out-of-date, as otherwise an additional amount of capital will become immediately necessary to equip the works with up-to-date plant. Further, it should be seen that the business is not burdened with some onerous leasehold, as this would adversely affect the value of goodwill.

MONEY MARKET CONDITIONS.—The state of the money market must necessarily affect the negotiable value of goodwill, for it can hardly be denied that when money is easy, more buyers will be found willing to acquire established concerns and pay higher value for goodwill than when money is scarce.

MODE OF PAYMENT.—The value of goodwill will also be considerably affected by the mode of payment. Thus, if the goodwill amount is to be paid to the vendors by the issue of fully-paid deferred or ordinary shares in a Company newly registered, where such shares will have hardly any marketable value, the vendors may expect a larger amount to be paid in respect thereof than if such payment was to be made in cash.

GOODWILL OF A COMPETITIVE BUSINESS.—It occasionally happens that a trader or a company may desire to acquire a competitive business in order to kill competition which would otherwise have to be faced. Under this circumstance, the purchaser would certainly be prepared to pay a large amount for goodwill in spite of the fact that such business may not be yielding super-profits and there may be no probability of the same being earned in the future.

It must be apparent from the above, how difficult it is to formulate any general rules as to the proper valuation of goodwill, as each individual case would possess its special features, and these would have to be fully considered before arriving at any fair estimate of its value.

VALUATION OF GOODWILL

As has already been seen, there are so many factors which enter into a computation of the goodwill of a business and its value depends on so many varying contingencies, that a good deal of care and consideration must be devoted before arriving at a fair value thereof. Again, so many different methods are employed in arriving at the value of goodwill, that it becomes

difficult to lay down any hard and fast rules as to the precise basis for its valuation.

To begin with, it should be understood that money can always earn an appropriate annual interest, and the rate of such interest depends upon the degree of risk incidental to the nature of its employment. Thus 4 to 5 per cent interest can always be earned by investing money in gilt-edged securities without subjecting one's capital to any risk. But as there is always a certain amount of risk involved where money is invested in business, the investor would naturally seek to earn a higher percentage of yield than would be returned from gilt-edged securities, and it follows that the greater the risk incidental to the employment of capital, the higher the percentage of interest that would be looked to as a normal return on the capital. Thus, whereas in an ordinary trading concern involving slight risk of capital, 10 per cent may be considered as a normal return, the same may not be deemed as adequate in an industrial enterprise involving larger risks.

Before, therefore, it can be said that a particular business has an exchangeable value of goodwill attached to it, it must be seen that the annual profits which that business is expected to earn in the future will exceed the normal return on the capital invested, with due regard to the nature of the risk involved. In other words, while determining the value of goodwill, the purchaser has mainly to ascertain as to what future annual super-profit he can reasonably expect from the business he wishes to acquire; and for this purpose, super-profit may be defined as the amount by which the future profits of any undertaking are likely to exceed a normal rate of interest as would ordinarily be earned in a like business.

The first step towards arriving at a fair exchangeable value of goodwill is to ascertain the net annual earnings of the business. For this purpose, it would not be safe to take the net earnings of any *one* normal year, but to find out, after a careful and exhaustive investigation of the books of accounts, the average net annual earnings on the basis of the past three to five years. From the average net profits thus arrived at, there should be deducted interest of at least 6 per cent on the capital outlay involved in the carrying on of the business, and a sum as would cover the proprietor's services to the business, if the same has not been charged against the profits, in the past.

The annual profits ascertained for the purpose of business should not as a rule be taken as the basis for goodwill valuation. Such profits will have to be carefully scrutinised, and, if need be, adjusted in the light of conditions likely to prevail in the future. With this object in aim, the Profit and Loss Accounts of the period determined upon will have to be recast so that a fair estimate of the profits likely to be earned in the future may be arrived at. Thus, adjustments would have to be made in regard to exceptional gains or losses, such as profit or loss from speculation, profit or loss arising from insurance claim, profit or loss from exceptional contracts not likely to be renewed, or gain or loss arising from an action for damages.

Similarly, income from assets not taken over, and items of Capital Profits or Losses such as profit or loss on sale of Investments or other fixed assets will have to be eliminated.

The prospective purchaser, having thus ascertained the probable net annual income to be derived from the business he is out to take over, must next determine how much of such income represents an *excess over* what would be deemed to be a *fair return* on the capital outlay involved on the acquisition of such business with due regard to the risks involved. The purchase-price of goodwill thus resolves itself into the *value of expected super-profits* over a certain number of years, that is profits in excess of a reasonable return on the amount invested in the acquisition of the net tangible assets (i.e. assets *minus* liabilities) of the business. The only question that then remains to be settled is for the purchaser to come to an agreement with the vendor as to the number of years for which such excess shall be paid for. The number of years' purchase also varies considerably, but this will mostly depend on the expectation of the business likely to yield similar results in the future to what it did in the past. Thus, the price to be paid for goodwill is at best a matter of negotiation between the buyer and the seller and also dependent on the form of purchase consideration, that is, whether it is to be paid for in cash or kind.

There are instances where the amount agreed upon for goodwill ranges from the payment of five to ten years of the *super-profits* as above explained outright.

Sometimes, the price payable for goodwill is taken as equivalent to two to five years' total net profits, adjusted in the light of likely future conditions and after deduction of interest on the necessary capital employed at a certain rate and an amount to provide for Management Salary, if the same has not been charged in the past.

A rough and ready method that is largely employed for ascertaining the value of goodwill is to take it as being worth one to three years' purchase of the annual profits of the business, such profits being based on the average annual profits of the two to five years immediately preceding the date of such valuation, without any deduction in respect of interest on capital and owner's services.

There have been extreme cases where the amount of goodwill has been ascertained by capitalising the super-profits of five to ten years.

The goodwill of an established newspaper concern is usually taken at from five to ten years' purchase of the average profits.

Other things being equal, the goodwill of a manufacturing concern will as a rule be less than that of a wholesale or retail business, as the former would require a much larger amount of capital and would generally involve greater risks than in the case of the latter type of business, either on account

of the monopolised conditions being lost, or the patented article being displaced in public favour, or the plant becoming obsolete due to new inventions.

The goodwill of a professional business would be still less, as the personality of the former owners must necessarily have formed a vital factor in the success of the business, and its value will thus be chiefly influenced by the continuity or otherwise of the former proprietors in the activities of the new firm.

In any case, the most vital fact to be remembered by the purchaser is that the figures of profits presented to him for verification and scrutiny represent only what the concern has achieved in the past, and although these may be taken as a guide for the purpose of basing future estimates, they cannot be regarded as any guarantee that equally profitable results will follow in the future. The amount of goodwill is, no doubt, paid by him in the hope and the chance that the benefit arising from the reputation and connections already formed will continue in the future, and the fact that whereas he would be taking a share in the future profits from a ready-made business for which the old proprietor or proprietors had laboured in the past, he would be saving himself the risk of capital and the trouble and anxiety he would have had to undergo if he were to start an entirely new business on his own. But, unforeseen contingencies might crop up as would upset his most sanguine expectations and most careful calculations, and bearing this in mind, he would always be wise to err on the side of under-valuation in the matter of this asset of the most fluctuating and unreliable character.

CHAPTER XVI

REVISIONAL NOTES FOR EXAMINEES

The following brief summary of the general Principles of Auditing, which have been elaborately discussed throughout the pages of this work, has been given to assist students appearing for examinations, and it is hoped the same will be found considerably helpful in enabling them to recapitulate the fundamentals involved.

AUDIT OF PURCHASES BOOK

Checking to be Done

1. Verify entries from Inward Invoices as to (a) Date; (b) Name of Supplier; (c) Contents; (d) Amount; and (e) proper Analysis, if any.
2. Check postings to credit of Personal Accounts of Suppliers.
3. Check additions of Purchases Book.
4. Check postings of Periodical Totals to debit of Purchases Account.
5. See that no entry is left unposted.
6. Make notes of Invoices missing and obtain duplicates.
7. Make notes of any irregularities for future inquiry.

Points to be Remembered

1. All Invoices should be in the name of the client.
2. All purchases must be in the usual course of the business.
3. See that purchases of fixed assets are not entered in the Purchases Book.
4. See that all Invoices are passed by someone in authority.
5. Ascertain that all goods taken in stock are entered in the Purchases Book.
6. See that purchases for proprietors', directors' or managing agents' personal use are charged to their personal accounts.
7. Make sure that no Purchase Invoice is entered twice.
8. See that Goods-in-transit are properly brought into account.
9. Ascertain how Forward Purchase Contracts are dealt with.
10. Make notes of any unusual or doubtful entries to be further enquired into.
11. See that Goods received on Consignment are not entered in the Purchases Book.
12. See that all Invoices are serially numbered and these numbers are shown against their respective entries in the Invoice Book.

AUDIT OF SALES BOOK

Checking to be Done

1. Verify entries from Outward Invoices as to (a) Date; (b) Name of Customer; (c) Amount; and (d) Analysis (if any).
2. Check postings to debit of Personal Accounts of Customers.
3. Check additions of Sales Book.
4. Check postings of Periodical Totals to credit of Sales Account.
5. See that no entry is left unposted.
6. Make list of Outward Invoices missing, if any.
7. See that all alterations on the Sale Invoices are duly authenticated.
8. Take note of any unusual discount or allowance, if any, deducted.

Points to be Remembered

See that—

1. No Sale Invoice is omitted to be entered.
2. Cancellation of any Sale Invoice is duly authenticated.
3. Only goods sold and delivered are entered.
4. Sales for Future Delivery are not entered.
5. Sales of discarded assets are not entered in this book.
6. Goods sent on Consignment are not mixed with sales proper.
7. Sales as Consignee are not included.
8. Goods sent out on Sale or Return are entered only after approval by customers.
9. Sales in the last month are not unduly heavy.
10. All Sale Invoices are serially numbered, and their numbers are shown against their respective entries in the Sales Book.
11. All Sale Invoices are signed by some authorised person.

AUDIT OF RETURNS BOOKS

Checking of Purchase Returns Book

1. Check entries from Credit Notes as to (a) Date; (b) Name of Account; and (c) Amount.
2. Check postings to debit of Personal Accounts of Suppliers.
3. Check additions.
4. Check postings of Periodical Totals to credit of Returns Outwards Account.

Checking of Sales Returns Book

1. Check entries from Credit Notes as to (a) Date; (b) Name of Account; and (c) Amount.

2. Check postings to credit of Personal Accounts of Customers.
3. Check additions.
4. Check postings of Periodical Totals to debit of Returns Inwards Account.

Points to be Remembered

1. All cancellation or alteration of Debit or Credit Notes should be duly authenticated.
2. Any unduly heavy Return should be enquired into.
3. Any irregularities should be noted.
4. Lists should be made of Debit or Credit Notes not available.

AUDIT OF CASH TRANSACTIONS

Vouching of Cash Receipts

1. See that each item received is properly entered in the Cash Book as to date, amount, and name of account.
2. Cash Sales should be vouched with cash memo books.
3. Receipts from Debtors should be checked with Counterfoil Receipt Books.
4. Interest and Dividends received should be verified with Bank Memos, Pass Books and other documentary evidence.
5. Commission received should be checked with relative statements.
6. Rents received should be vouched with Counterfoil Receipts and traced into Rent Rolls.
7. Proceeds from Sale of Shares should be vouched with Brokers' Contract Notes.
8. Proceeds from Sale of Landed Property, Plant or Fixtures should be vouched with auctioneer's account or with sale contracts.
9. Bills Receivable received or discounted should be verified with the Bills Receivable Book.

Vouching of Cash Payments

1. It should be seen that each payment is properly entered as to date, name of account, and amount.
2. The vouching of payments will necessitate verification of:—
 - (a) Wages with Wages Sheets.
 - (b) Salaries with Salaries Book.
 - (c) Commissions with Receipts and Agreements.
 - (d) Payments to Creditors with acknowledgments and Statements from Creditors.
 - (e) Travelling Expenses with duly authenticated vouchers.

- (f) Railway Freight and Custom Duty with accounts rendered by authorities.
- (g) Establishment Charges, such as Taxes, Insurance, Advertising, Lighting, etc., with usually recognised vouchers.
- (h) Dividends with returned Dividend Warrants.
- (i) Debenture Interest with Debenture Interest Book and Bank Pass Book.
- (j) Bills Payable with returned Bills.
- (k) Investments with Brokers' Bought Notes.
- (l) Patents and Copyrights with relative contract for sale.
- (m) Plant and Fixtures with auctioneer's accounts or acknowledgments from vendors.
- (n) Hire-Purchase Payments with Hire-Purchase Agreement and acknowledgments from payees.
- (o) Partners' Drawings with Drawings Book.
- (p) Bank Charges and Bank Interest with Bank Pass Book.
- (q) Directors' Fees with their acknowledgments and Directors' Attendance Book.

Sundry Checking of Cash Book

1. Postings from receipts side to be checked to the credit of the accounts concerned.
2. Postings from payments side to be checked to the debit of the accounts concerned.
3. Additions of Cash, Bank and Discount Columns should be cast.
4. Postings of Periodical Totals of Discount Columns should be seen—
from debit side, to the debit of Discount Account, and
from credit side, to the credit Discount Account.
5. Items from Bank Columns should be checked into the Bank Pass Book.
6. Bank Reconciliations should be verified.
7. Bank Certificates should be seen as to the closing Bank Balances.
8. Cash Balance should be verified by actual count.

Points to be Remembered

1. Any irregularities in use of counterfoil receipt books should be noted.
2. Any cancellation of or alteration on cash memo should be authenticated.
3. Any counterfoil receipts missing should be noted.
4. All payment vouchers must be passed and initialled by some one in authority.

5. Any unusual or irregular payment must be noted and inquired into.
6. Client's instructions as to banking of cash receipts should be strictly observed, and any deviations therefrom should be reported.
7. Cash balance should not be unduly heavy.
8. It should be seen that any allocation between capital and revenue is properly done and duly authenticated.
9. Repairs to Building, Plant, Fixtures, etc., are not to be capitalised.
10. List of vouchers missing or not available should be made and duplicates should be obtained—if not available, the matter should be reported upon.
11. Any Bank Certificate not available should be noted and reported.

AUDIT OF PETTY CASH TRANSACTIONS

This will call for the following steps:—

1. Imprest Cheques to be checked from Cash Book into the Petty Cash Book.
2. All payments to be vouched with relative vouchers, or test vouching should be done of a period selected.
3. Postings of analytical columns to be checked.
4. Castings to be checked.
5. Any irregularities to be noted.
6. List of missing vouchers to be made.

AUDIT OF BILL TRANSACTIONS

Checking of Bills Receivable Book

1. Check Bills realised into the Cash Book.
2. Verify Bills Discounted into the Cash Book and the Bank Pass Book.
3. Check posting of each Bill to credit of Personal Account concerned.
4. Trace Dishonoured Bills to debit of Personal Accounts.
5. Check castings.
6. Check postings of Periodical Totals to debit of Bills Receivable Account.
7. Verify Unmatured Bills as shown by the Bills Receivable Book by actual inspection or with the banker's letter, and agree the total amount with the balance on Bills Receivable Account.
8. Provision for Doubtful Debts should be considered in respect of Overdue and Dishonoured Bills.
9. Any irregularities should be noted and inquired into.

Checking of Bills Payable Book

1. Trace Bills met into the Cash Book, and verify the same with returned Bills.

2. Check postings to debit of Personal Accounts.
3. Check additions.
4. Check postings of Periodical Totals to credit of Bills Payable Account.
5. Agree the total amount of Unmatured Bills as per the Bills Payable Book with the Balance on Bills Payable Account.
6. Any returned Bill Payable missing should be noted.

AUDIT OF JOURNAL PROPER

1. Every entry should be supported by a duly authorised voucher.
2. Opening Entries should be verified with last Balance Sheet.
3. The following should be properly authenticated:—
 - (a) Allowances, and Bad Debts
 - (b) Transfers from Revenue to Capital or *vice versa*
 - (c) Rectification Entries
 - (d) Sale or Return Entries
 - (e) Transfer from one Personal Account to another
 - (f) Allocation of Expenditure between Capital and Revenue.
4. Consignment Transactions should be checked with Consignment Books and Account Sales.
5. The following Adjusting Entries should be carefully scrutinised:—
 - (a) Outstanding Liabilities
 - (b) Income accrued due
 - (c) Income received in advance
 - (d) Expenses prepaid
 - (e) Depreciation
 - (f) Reserve for Doubtful Debts
 - (g) Bad Debts written off
 - (h) Transfers.
6. Unusually heavy discount should be noted.
7. Dishonoured Bill Entries should be checked with Banker's letter, Bill or other evidence.
8. Closing Entries should be checked into the Final Accounts.
9. Postings should be checked.
10. List of missing vouchers should be made.
11. Any unusual entry should be noted and thoroughly scrutinised.

VERIFICATION OF STOCK-IN-TRADE

1. Stock Certificate signed by some authorised person should be seen, stating mode of valuation.

2. Additions of Stock Sheets should be checked.
3. A few costly items should be tested as to price with original Invoices.
4. Extensions of some of the big items should be tested.
5. If Stock Records are maintained, some items of Stock Inventories should be tested with Stock Book balances.
6. Basis of Valuation should be reasonable and consistent.
7. Any unusual fluctuation in stock should be enquired into.
8. Goods entered in Sales Book, if undelivered, should not be included.
9. Inward Consignment Stock should not be included.
10. Stock of Stationery or Printed Matter should not be included in Stock-in-Trade, but should be separately shown.
11. Stock in Bonded Warehouses should be checked with their relative documents.
12. It should be seen that all goods included in stock have passed through the Purchases Book.
13. If goods are supplied to Branches at Selling Price, Branch Closing Stocks should be adjusted and brought in at Cost Price.
14. Where Outward Consignment Goods are invoiced at *Pro Forma* prices, any unsold Consignment Stock should be brought down to Cost Price.
15. If the Market Price of the Stock has gone down below cost, the valuation must be at Market Price.
16. It should be seen that stock of obsolete or shop-soiled goods is not valued beyond its likely realisable price.

VERIFICATION OF SUNDRY DEBTORS (BOOK DEBTS)

1. Postings from various Subsidiary Records should be checked into the Debtors' Ledgers.
2. Additions of Debtors' Accounts and balances brought down should be checked.
3. Balances on List of Sundry Debtors should be checked with Ledger Accounts.
4. List of Overdue Accounts should be obtained.
5. See to all Bad Debts being written off.
6. See that Overdue Accounts are adequately provided for.
7. Obtain letter from someone in authority as to adequacy of Provision for Doubtful Debts, and test the same with the List of Doubtful Debts.
8. All Bad Debts written off should be duly authorised.
9. Transfer from one Personal Account to another should be carefully scrutinised and duly authorised.
10. Unduly heavy allowances or discounts should be noted and enquired into.

11. Balances owing by *Customers only* should be included in the List of Debtors.

12. Debtors for Loans or Advances against Goods, Plant, etc., should be separately shown.

13. See that no entry appears directly in the Debtors' Ledger.

14. If acknowledgments have been received from Debtors as to correctness of their balances, verify these.

15. See that any debt in dispute is provided for.

16. Any credit balances on Customers' Accounts should be carefully scrutinised, and shown separately as a liability.

17. Advances to Staff should be separately stated.

18. Any irregularity on any customer's account should be brought to the client's notice.

VERIFICATION OF SUNDRY CREDITORS (TRADE SUPPLIERS)

1. Check postings of entries from the Subsidiary Records into the Creditors' Ledger.

2. Check additions of Ledger Accounts and the balances brought down.

3. Check balances on List of Sundry Creditors with the Creditors' Ledger Accounts.

4. Irregularity on any account should be noted.

5. Statements, if any, obtained from Creditors, should be checked to verify closing balances.

6. No entry should appear directly in the Creditors' Ledger.

7. Liabilities on Loans borrowed should be separately shown.

8. Any debit balances on Suppliers' Accounts should be thoroughly scrutinised, and shown separately as an asset.

9. Any claims made by creditors, if not provided for, should be shown as Contingent Liabilities.

10. Balances on accounts of *Trade Suppliers only* should be included in the List of Sundry Creditors.

11. Balances of long standing must be thoroughly scrutinised to ascertain if they represent any real liability.

VERIFICATION OF TRIAL BALANCE

1. While checking additions and balances of all Ledger Accounts, examine both sides of Accounts to see that no item is left unposted.

2. Check Ledger Balances into the Trial Balance.

3. Verify the agreement of the Trial Balance.

4. See to proper inclusion of Adjusting Entries in the Trial Balance.

5. Check the items from the Trial Balance into the Trading and Profit and Loss Account and the Balance Sheet.

VERIFICATION OF TRADING AND PROFIT & LOSS ACCOUNT

1. Check each item from the Trial Balance.
2. A comparison with previous year is highly desirable.
3. Compare percentage of Gross and Net profits on Sales with those of the previous year, and obtain satisfactory explanation in case of any violent fluctuation.
4. The form of the Trading and Profit and Loss Account should be consistent.
5. Each item of income or expense should appear under its correct head.
6. Revenue charges should not be wrongly capitalised.
7. Capital items should not be wrongly debited or credited to Revenue.
8. Proper allocations and adjustments should be seen as to—
 - Outstanding Expenses
 - Prepaid Expenses
 - Income accrued
 - Income received in advance
 - Bad Debts
 - Provision for Doubtful debts
 - Depreciation.
9. Profit or Loss on any asset realised should be distinctly shown.
10. No unearned profit should be brought in.
11. All losses accrued or anticipated should be brought in.
12. Any unusual item should be noted and enquired into.
13. Any extraneous source of gain should be specifically shown.

VERIFICATION OF BALANCE SHEET (OF A SOLE TRADER)

1. Balances of all assets and liabilities should be checked from the Trial Balance into the Balance Sheet.
2. Every asset or liability should appear under its appropriate head.
3. Additions to Fixed Assets should be scrutinised to see that they represent real capital expenditure.
4. Leases or Title Deeds of landed properties should be inspected.
5. Depreciation on Assets should be looked into to see that it is consistent and adequate.
6. Stock Certificates should be seen, and mode of valuation should be shown on Balance Sheet.
7. Sundry Debtors' List should be scrutinised to ascertain debts of long standing.
8. List of Doubtful Debts should be gone through with management.

9. Close and careful scrutiny should be made as to proper valuation of—

- (a) Stock-in-Trade
- (b) Investments
- (c) Book Debts
- (d) Patterns and Drawings
- (e) Patents
- (f) Copyrights
- (g) Live Stock
- (h) Stock-in-Process
- (i) Uncompleted Contracts
- (j) Stock of Stationery and Advertising Matter.

10. Prepaid Expenses should be scrutinised.

11. Advances to staff and other loans advanced should be verified with relative vouchers.

12. Investments should be verified by actual inspection or with Banker's Certificate.

13. Accrued Interest should be checked.

14. Mode of Valuation of Investments should be ascertained and clearly shown on the Balance Sheet.

15. Bank Balances should be verified with Pass Books, Reconciliations and Bank Certificates.

16. Cash on hand should be verified by actual count.

17. Loans borrowed should be verified with relative documents.

18. Outstanding Interest on loans borrowed should be properly brought in.

19. Sundry Creditors' List should be scrutinised, and the balances should be checked with statements from Creditors.

20. All Outstanding Liabilities should be ascertained and brought in.

21. Specific inquiries should be made to ascertain—

- (a) If there are any disputed claims;
- (b) If any assets are mortgaged or pledged;
- (c) If there are any heavy liabilities on forward contracts;
- (d) If all outstanding liabilities have been included; and
- (e) If full provision has been made for Doubtful Debts.

22. Structural alterations, repairs and replacements should receive special scrutiny.

23. If original cost of any asset is increased on re-valuation, Balance Sheet must clearly disclose the fact.

24. Loss on sale of fixed assets should be adjusted.

25. Sundry Debtors should include balances of Customers only, and Sundry Creditors, balances of Trade Suppliers.
26. Any variation in Depreciation percentage should be noted.
27. Organisation or Development Expenses, if carried forward, should receive close scrutiny.
28. If any assets are mortgaged or pledged, Balance Sheet must clearly disclose the fact.
29. Final Accounts should be discussed with the client before signing.
30. Any Contingent Liabilities should be stated by way of a foot-note.

PARTNERSHIP AUDIT (SPECIAL POINTS)

1. Partnership Deed should be inspected, and it should be seen that the clauses therein as to accounts are strictly followed.
2. Capital Account of each Partner and the Drawings of the Partners should be in order.
3. Interest on Capital and Drawings should be as agreed upon.
4. Proper Division of Profits as per the Partnership Deed should be looked to.
5. Salaries, if any, drawn by Partners should be in accordance with the Deed.
6. If any Partner has introduced Loan, the question of Interest thereon should be ascertained.
7. Drawings by a Partner above the agreed amount should be brought to the notice of all the Partners.
8. In case of an Incoming Partner, the terms of Admission should be ascertained and it should be seen that the adjustments made in this behalf are proper.
9. In case of Death or Retirement of a Partner, the agreement should be carefully scrutinised to verify the proper adjustment of Capital, Profits and Goodwill.
10. Decisions of Partners in matters of Accounts, if minuted, should be verified.
11. Partners' attention should be invited to any deviation from the Partnership Deed.
12. Final Accounts should first be discussed before a meeting of all the Partners before certifying.
13. Audited Accounts may advantageously be signed by all the Partners as evidence of their approval.
14. It should be seen that nothing is done in the matter of accounts by any one or more partner or partners to the detriment of the others.

LIMITED COMPANY (STATUTORY AUDIT)

Verification of Share Capital Transactions

1. The Memorandum, the Articles and the Prospectus should be studied.
2. Allotment Lists should be verified with the Application and Allotment Letters.
3. Directors' Minutes regarding Allotment should be seen.
4. Counterfoil Receipts for Application and Allotment should be checked into the Cash Book and the Application and Allotment Book.
5. Payments in and out of Bank Accounts should be traced into Bank Pass Books.
6. Returns of Application money, if any, should be traced into the Cash Book and the Directors' Minutes.
7. Transfer of Excess Application money (if any), to Allotment Account should be verified.
8. Directors' Minutes regarding Calls should be seen.
9. Call moneys received should be verified from Counterfoils of Receipts into the Cash Book, Share Call Book and the Bank Pass Book.
10. See that the Provision as to Minimum Subscription in the Articles and the Prospectus has been duly fulfilled.
11. Verify forfeiture of Shares, if any, with the Directors' Minutes and the Articles.
12. Check the entries from the Share Application and Allotment Book and the Call Book into the Share Register.
13. Agree the total amount of Share Capital Subscribed and Received as ascertained from Share Register with the Share Capital Account in the Financial Ledger.
14. See that the Share Capital Issue is in terms of the Prospectus.
15. Contracts with Vendors should be seen to ascertain that the issue of fully or partly-paid shares is in order.
16. See that Minimum Subscription was obtained prior to Allotment.

Verification of other items

1. See that the Debenture Issue is in terms of the Articles and the Prospectus.
2. Vouch Debenture Receipts in the same manner as Share Capital Receipts.
3. Check Commission to Underwriters with their Contracts and the disclosure in Prospectus.
4. See that the Underwriting Contracts have been duly carried out.

5. Check Brokerage on Shares or Debentures with the provision in the Articles and the Prospectus.
6. Vouch all payments capital and revenue with their relative acknowledgments, vouchers, contracts or any other documentary evidence.
7. Scrutinise carefully the Preliminary Expenses to ensure that they contain legitimate items only.
8. Scrutinise all Capital Expenditure and ascertain that the same is duly authorised.
9. Verify Bank Transactions with Bank Pass Books and see that all Bank Accounts are reconciled.
10. Obtain Bank Certificates as to closing Bank Balances.
11. Verify cash balance on hand by actual count.
12. Check Statement of Receipts and Payments and see to the proper form of Auditor's Certificate.

Points to be Remembered

1. Section 77 deals with Statutory Report.
2. Section 101 places restrictions on First Allotment of Shares.
3. Section 103 places restrictions on Commencement of Business.
4. Section 105 relates to payment of Commission for procuring Share Subscriptions.
5. Statement of Receipts and Payments should be made up to a date within seven days of the Report.
6. Moneys received from Share and Debenture Applicants should be banked intact into a Schedule Bank upto Commencement Certificate. (Section 101).
7. Facts disclosed in the prospectus should correspond with the Articles.
8. Ascertain restrictions on the Company's Borrowing Powers.
9. Preliminary Expenses should not exceed the amount declared in the Prospectus.
10. Arrears of Calls due from Directors, Managing Agents and Managers should be specifically stated.
11. See that Brokerage on Shares or Debentures is paid only to *bona fide* brokers, and the rate does not exceed that authorised by the Articles and disclosed in the Prospectus.
12. Commission or Brokerage on Issue of Shares to any Director, Managing Agent or Manager should be separately stated.
13. See that the Directors have taken up and paid for their Qualification Shares.
14. 'Statutory Books' should be written up to date and should contain information as required by the Act.

15. Contract for issue of fully or partly-paid shares should be filed with the Registrar.

16. The following should be verified with the Board's Minutes:—

- (a) Appointment and remuneration of Managing Director
- (b) Appointment and remuneration of Managing Agents
- (c) Ratification of Underwriting Contract (if any)
- (d) Ratification of Contract with Vendors (if any)
- (e) Issue of Prospectus
- (f) Allotment of Shares and Debentures
- (g) Calls made
- (h) Forfeiture of Shares
- (i) Capital Expenditure
- (j) Allotment of Fully or Partly-paid Shares
- (k) Loans borrowed
- (l) Loans granted
- (m) Mortgage or pledge of any asset
- (n) Appointment of Auditors
- (o) Re-issue of Forfeited Shares.

17. If Interest has been paid on Capital during Construction, see that all the requirements under Section 107 are duly complied with.

LIMITED COMPANY (ANNUAL AUDIT)

Verification of Profit and Loss Account

The Profit and Loss Account of a Company would need (in addition to the scrutiny of usual Revenue items) verification of:—

1. Remuneration of Managing Agents with their Agreement, the Articles and the Prospectus.

2. Directors' Fees with the Articles and the Attendance Register or the Minute Book.

3. Managing Directors' Remuneration with the Board's Resolution and the Agreement (if any).

4. Preliminary Expenses written off, with the Board's Resolution.

5. Brokerage on Shares or Underwriting Commission written off with the Board's Resolution.

6. Deferred Revenue Expenses written off as per the Board's Resolution.

7. Discount on Debentures written off as per the Board's Resolution.

8. Depreciation written off with the Board's Resolution.

9. Bad Debts written off being duly authorised.

10. Provision for Doubtful Debts with the Board's Resolution.

11. Due authorisation of any increase in salary.

12. Proper Internal Check over wage payments, a strict control over purchase and issue of raw materials and stores, and a sound and reliable system of Cost Accounts will form subject-matters for special inquiry, in case the company happens to be a manufacturing concern.

Checking of the Assets Side of Balance Sheet

1. Verify Fixed Capital Expenditure, as per last Balance Sheet.
2. Particularly scrutinise additional Fixed Assets acquired.
3. Enquire into the question of adequacy of Depreciation.
4. See Directors' Resolutions as to the treatment of—
 - (a) Brokerage on Shares or Debentures
 - (b) Underwriting Commission
 - (c) Discount on Issue of Debentures
 - (d) Preliminary Expenses
 - (e) Allotment of further Shares or Debentures
 - (f) Further Calls made
 - (g) Additional Capital Expenditure
 - (h) Loans borrowed
 - (i) Loans advanced
 - (j) Investments made
 - (k) Reserves made.
5. Verify Stock-in-trade with Stock Sheets.
6. Obtain Stock Certificates from responsible official clearly stating the mode of valuation.
7. •Verify Unmatured Bills Receivable on hand.
- 8. Verify Book •Debts, ascertain adequacy of Provision for Doubtful Debts, and see to the proper classification of the Book Debts.
9. See that Advances to the Staff are in order.
10. Verify Securities lodged by Employees, if any.
11. Check Loans advanced, see to the interest realised thereon and accrued interest being properly brought in.
12. Verify Securities of Provident Fund, if any.
13. Verify Securities against Loans advanced, and see that the latter are sufficiently covered.
14. Verify the Company's own Investments by actual inspection or with Banker's Certificate, and ascertain the mode of valuation.
15. Check accrued and outstanding Interest on Investments.
16. Verify Cash Balance by actual count.
17. Verify Bank Balances with Reconciliations, Bank Pass Books and Bank Certificates.

Checking of the Liabilities Side of Balance Sheet

1. See that the Share Capital is properly set out distinguishing between Authorised, Subscribed, Called up and Paid-up Capital, and the different classes of Shares.
2. Check further Issue of Shares or Debentures (if any), in detail.
3. Check further Calls made (if any).
4. See that the Share Register agrees with the Financial Ledger.
5. Verify Calls in Arrears.
6. Verify Forfeited Shares with power under the Articles and the Board's Resolution.
7. Check Reserves made as per the Shareholders' Resolution.
8. See that Articles or Resolutions as to Specific Reserves are duly complied with.
9. Verify the Provident Fund and its Investments, and see that all regulations in relation thereto are duly carried out.
10. Verify Debenture Issue with Board's Borrowing powers and resolution.
11. Check Outstanding Interest thereon.
12. See that Debenture Redemption Fund is maintained in due accordance with the Terms of Issue of Debentures.
13. Verify Secured Loans borrowed.
14. Verify Unsecured Loans borrowed.
15. Verify other Liabilities:—
 For Goods Supplied,
 For Expenses Outstanding,
 For Bills Payable, and
 For other Finances.
16. See that Contingent Liabilities are stated at foot of the Balance Sheet.
17. Verify statement as to Arrears of Cumulative Preference Shares.
18. Check Dividends declared with the Shareholders' Resolution.
19. See Directors' Resolution for Interim Dividend, if any, declared.
20. Verify other appropriations out of Profits with the Shareholders' Resolution.

Sundry Requirements

1. Obtain Board's Letter regarding the following:—
 - (a) Adequacy of Provision for Doubtful Debts;
 - (b) That all Outstanding Liabilities have been fully brought into account;
 - (c) That there are no disputed claims against the Company;

- (d) That there are no pending Law Suits except those disclosed;
 - (e) That there is no other mortgage or pledge of assets except what is disclosed;
 - (f) That there are no Contingent Liabilities except those stated.
2. Contents of Balance Sheet to be stated and classified as per Form F.
 3. Ascertain that proper Books of Account have been maintained.
 4. See that all Statutory Books are properly maintained.
 5. See to the proper wording of the Auditor's Report.

Points to be Remembered

1. Fixed Assets should appear at original cost.
 - Any additions to be shown separately.
 - Any deductions to be shown separately.
 - Depreciation to be shown as a deduction from the relative asset.
 - Valuation to be fair and consistent.
 - Mortgage or pledge of assets to be specifically shown.
 - Any excess added as a result of re-valuation to be specifically stated.
2. Mode of Valuation should be clearly stated of—
 - Stock-in-trade.
 - Investments.
3. Book Debts should be distinguished between—
 - Secured and Unsecured.
 - Good and Doubtful.
 - Debts owing by Directors and Managers.
4. Investments should be distinguished between—
 - Government Securities.
 - Shares and Debentures in other companies.
 - Shares and Debentures in Subsidiary companies.
 - Fully and Partly-paid Shares.
5. Deferred Revenue Expenditure should be specifically stated.
6. Any capitalisation of Revenue Expenditure should be carefully scrutinised.
7. Secret Reserve should not exceed legitimate limits.
8. Calls due from Managing Agents or Directors should be separately stated.
9. If Debentures are secured, nature of security should be stated.
10. Provision should be made for Redemption of Debentures according to Debenture Trust Deed or Terms of Issue.

11. Sinking Fund for Replacement of any asset should be separately stated.
12. Secured and Unsecured Loans should be classified as required in the Prescribed Form F.
13. Unclaimed Dividends should be separately stated.
14. Directors' Travelling Expenses for attending Board Meetings should be authorised either by the Articles or Resolution at General Meeting.
15. Articles or Agreement, if any, with Managing Director, and Managing Agents should be seen.
16. Quorum at Directors' meetings should be watched.
17. Minimum number of Directors should be three. (Section 83A.)
18. Loans or Guarantees to Directors are forbidden by Section 86D.
19. Loans to Managing Directors or Managing Agents are forbidden by Section 87D.
20. Any excess withdrawal by Directors or Managing Agents' should be specifically shown in the Balance Sheet.
21. Loans from Directors or Managing Agents should be specifically shown.
22. Directors should not hold office of Profit without sanction of General Meeting. (Section 86E.)
23. The above also applies to a firm of which such Director is a partner, or a Private Company of which such Director is a director. (Section 86E.)
24. Consult Section 86F regarding restrictions on Directors contracting with the Company.
25. Director's interest in any contract should be disclosed at a meeting of Directors. (Section 91A.)
26. Interested Director should not vote at such meeting, and his presence will not be counted for quorum. (Section 91B.)
27. Manager's or Managing Agents' remuneration should be verified with the articles, agreement, and disclosure in the prospectus.
28. Managing Agents cannot contract with the Company without sanction of independent quorum of three-fourths of Directors present at such meeting. (Section 87D.)
29. Inter-company Loans are forbidden by Section 87E.
30. Restriction on purchase of shares of companies under same Managing Agents are laid down by Section 87F.
31. Section 87G puts restrictions on the part of Managing Agents as to issuing Debentures and investing the funds, unless authorised by the Directors.
32. Managing Agents' Directors should not exceed one-third of the total number. (Section 87I.)

33. Securities by Employees should be lodged in a Scheduled Bank. (Section 282B.)

34. Provident Fund contributions should be invested in Trust Securities. (Section 282B.)

35. Managing Agents' Remuneration and Directors' Fees should be specifically stated in the Profit and Loss Account. (Section 132.)

36. If any Revenue Expenditure is carried forward, the Profit and Loss Account must state the whole amount and the reason why only a small portion is charged to Revenue.

37. Any unusual item of gain or loss should be shown under distinct heading.

38. If Depreciation is not provided for, the fact must be disclosed in the Auditor's Report.

39. If the promoters have agreed to bear the whole or a part of the Preliminary Expenses, see that a proper adjustment is made in this behalf.

40. Where the company has acquired a running business, see that the several assets and liabilities have been brought in at proper values as per the Purchase Agreement.

41. If assets are written up as the result of a re-valuation, the fact must be clearly disclosed on the face of the Balance Sheet.

42. If assets have been written down by reduction of Capital, such reduction of Capital and Assets must be clearly stated on the Balance Sheet.

43. Where Debentures have been issued as Collateral Security, Balance Sheet must disclose the fact.

44. Where Redeemable Preference Shares have been issued, the requirements under Section 105B must be duly fulfilled.

45. Where Divisible Profits are rendered available by profits on the sale of an asset or by the writing up of an asset, carefully ascertain the legal position.

46. Where the business consists of Branches, see that periodical certified Branch Returns are properly incorporated.

INSURANCE COMPANY AUDIT

Verification of Revenue Account

1. Vouch Premium Income with Counterfoil Receipt Books.
2. Vouch Recoveries in respect of Re-insurances.
3. Vouch Interest and Dividends received.
4. Vouch Miscellaneous Receipts.
5. Examine Claims paid with Cancelled Policies and the Claims Register.
6. Vouch Payments to Annuitants with their acknowledgments.

7. Verify Surrenders Paid with endorsements on Policies and Receipts for money paid.
8. Verify Re-insurance payments with acknowledgments for money paid.
9. Vouch Commission to Insurance Agents with Receipts and Statements.
10. Vouch Commission and Allowances to Chief Agents with their Agreements, Receipts and Statements.
11. Vouch Salaries to Staff.
12. Verify Manager's Remuneration with Agreement.
13. Verify Directors' Fees with the Articles and Attendance Register.
14. Vouch other Expenses of Management with usually recognised vouchers.
15. See to Bad Debts written off being duly authorised.
16. Ascertain that common Management Expenses are fairly apportioned over the various Revenue Accounts.
17. See to proper provision being made in respect of—
 - (a) Outstanding Claims.
 - (b) Commission payable to Insurance Agents and Chief Agents.
 - (c) Travelling Expenses and Allowances due to Chief Agents, etc.
 - (d) Outstandings for Salaries, Rent, Taxes, Advertising, Medical Fees, Audit Fees, Actuarial Fees, etc., due.
 - (e) Interest accrued on Investments.
 - (f) Interest accrued on Loans on Mortgages.
 - (g) Interest accrued on Loans on Policies.
 - (h) Outstanding Premium.
18. See to the Revenue Accounts being prepared in Statutory Form.

Verification of Balance Sheet

1. Examine Loans on Mortgages of Properties and obtain Architects' Certificates as to Valuations.
2. Verify Loans on Stocks and Shares.
3. Verify Loans on Policies and see to their being within surrender values.
4. Verify Investments by actual inspection or with Certificates from Banks.
5. Check Interest Accrued and Outstanding on Investments and Loans granted.
6. See to the proper Classification of Loans and Investments.
7. Verify Agents' and Branch Balances with their relative statements.

8. Ascertain Doubtful Branch and Agency Balances and see to adequate provision being made in that respect.

9. Verify Outstanding Premiums to see that only instalments due upto date of closing are included.

10. Scrutinise Organization or Development Expenses and see the Board's Minute regarding the amount to be carried forward.

11. Check Bank Deposit Account Balances with relative receipts.

12. Verify Bank Current Account Balances with Pass Books and Bank Certificates.

13. Verify Cash Balance by actual count.

14. Check list of Outstanding Claims with Claims Register.

15. Ascertain that all claims intimated to date of closing are entered in the Claims Register.

16. See that all claims for Re-insurances outstanding are duly provided for.

17. Verify Commission and outstanding.

18. See that Commission payable on Outstanding Premium is provided for.

19. Examine Chief Agents' Agreements for Commission, Travelling Expenses and other Allowances paid as well as outstanding.

20. Examine Re-insurance Treaties and Agreements.

21. See that lapsed Policies are not allowed to stand in the Register.

22. Verify Life Revenue Surplus with Actuarial Valuation Certificate.

23. Verify Dividends declared with Actuarial Valuation and Shareholders' Resolution.

24. See to all Outstanding Liabilities being duly brought in.

25. See that all Contingent Liabilities are properly specified.

26. See to the Balance Sheet being drawn up in the Prescribed Form.

27. See to the Auditor's Report being worded in proper form.

Points to be Remembered

1. Ascertain System of Internal Check in force.

2. Total Premium Income can be verified by reference to Policy Registers, Renewals and Lapsed Policies, and agreed with the receipts after allowing for arrears, where detailed checking is dispensed with.

3. Agents' Expenses and Commission should be vouched with Receipts, and it should be seen that they are in accordance with agreed terms.

4. Loans on Policies should be checked to a reasonable extent with the Loans Register to see that these are within their Surrender Values.

5. Some Accounts in the Agents' Ledger should be tested with Returns from the Agents.

6. See that the Rate of Commission paid to Insurance Agents does not exceed the Scheduled Rate under the Act.

7. See that there is proper apportionment of Common Expenses over the several Departments.

8. Scrutinise Outstanding Branch and Agency Balances with their Statements and ascertain that they are all recoverable.

9. If the Market Value of Investments is less than the Book Value, see that the difference is provided for.

10. See that all Annuities due and unpaid are provided for.

11. Amounts due from Directors and Officers are to be specifically shown.

12. If any Guarantee is given by the Company in respect of policies of other Companies, the fact should be clearly disclosed in the Balance Sheet.

13. Contingent Liabilities should include Uncalled Capital on Shares held as Investments.

14. In case of Fire or Marine Insurance, see that due provision is made for unearned premium on unexpired risks.

15. See that Life Funds are invested as required by the Act.

16. Separate books should be maintained and separate Revenue Accounts should be prepared for each class of business.

17. Every item of Expense should appear under its appropriate head as shown on the Prescribed Forms of Revenue Accounts.

18. The proper working and investment of Pension or Superannuation Fund must be looked to.

19. If any Securities are deposited by the Company to cover any loan or liability, the fact must be clearly disclosed in the Balance Sheet.

20. Outstanding and accrued dividends and interest must be brought in less Income-tax.

21. Holdings in and Loans to or from Subsidiary Companies must be clearly stated in the Balance Sheet.

22. "Organization Expenses", or "Development Expenditure", should be most carefully scrutinised so as to include only legitimate items.

23. The salary paid to Managing Agent or Managing Director should be shown separately from Staff Salaries.

24. Examine the Trust Deed where Trustees to a Fund are appointed.

25. See that no commission is paid on business introduced direct to the Head Office without the help of an Agent.

26. Where part of the Company's Funds are held by another Company under any Treaty, a certificate in respect of the funds held by the latter should be obtained from the Company concerned.

27. All Outstanding balances should be agreed with available evidence.

28. Balance Sheet must state how the values of the Stock Exchange Securities are arrived at.

29. See that Claims Register and Register of Insurance Agents are properly maintained.

30. All Investments and Assets should be held in the name of the Company.

31. Examine Board's Resolutions in respect of—

(a) All claims paid.

(b) Any claims cancelled as not payable.

(c) Ratification of Treaties and Agreements.

(d) Appointment or dismissal of Managers, Chief Agents, Insurance Agents, etc.

(e) Investment of Company's Funds.

(f) Any Organization Expenses to be carried forward.

(g) Any increase in the salary of an official.

(h) Allocation of Common Expenses.

32. See to the proper incorporation of the periodical statements from the Branches, Agencies and Foreign Offices under Treaties.

33. Where transactions in Foreign Currencies are incorporated, see that the Rates of Exchange utilised for the purpose of conversion are clearly disclosed.

BANK AUDIT

Checking to be Done

1. Verify Cash Balance at date of closing.

2. See to Cheques received too late for clearing at date of closing cleared within the next few days.

3. Verify Certificates obtained from other Banks in respect of balances held by them.

4. Check balances of Fixed Loans from the Loan Ledger into the Schedules.

5. Check Overdrafts, Cash Credit Balances and other Loans from the relative Subsidiary Ledgers into the respective Schedules.

6. Check balances of Current Deposit Accounts into the Schedules.

7. Check balances of Fixed Deposit Accounts into the Schedules.

8. Check Totals of the above Schedules and agree the same with the balances on the corresponding Total Accounts in the General Ledger.

9. Verify by actual inspection the Securities lodged by customers, stock-brokers, etc., against loans granted.

10. Examine the market values of Securities held against loans to ascertain that such loans are adequately covered.
11. Verify by actual inspection Bank's own Investments, and scrutinise the basis of their valuation.
12. Verify Securities lodged by customers against Acceptances or Endorsements by the Bank on their behalf.
13. Verify by actual inspection a good number of Securities lodged in Safe Custody by customers with their corresponding Lists and Ledger Accounts.
14. Examine Loans on Mortgage of Properties with Architects' Valuations.
15. Examine Loans on Cotton, Yarn or other commodities with Bank's Stock Registers and Certificates.
16. Verify Loans against Produce with the valuation of a broker and Bank's Certificates.
17. Verify by actual inspection the Bills Unmatured on hand.
18. Verify Bills Discounted.
19. See that the provision made in respect of overdue Bills is adequate.
20. See that Rebate on Bills Discounted and Unmatured is adequately provided for.
21. Verify Bank's liability in respect of Acceptances and Endorsements on behalf of customers.
22. See to all Bad Debts being written off and Doubtful Debts provided for.
23. See that all Interest and Dividends received and all Interest and Dividends Outstanding and Accrued have been properly brought into account.
24. See that Interest payable on Fixed and other Deposits is duly provided for.
25. See that Depreciation in value of Securities is fully provided for.
26. Take note of Assets written off for purposes of Secret Reserve.
27. Enquire into Overdrawn Current Accounts being in order.
28. See that balances on Overdrawn Current Accounts are not deducted from the total Liabilities on Current Accounts.
29. See that limits, if any imposed, on Loan Accounts are not exceeded.
30. Ascertain the basis on which the transactions in Foreign Currencies have been assimilated in Head Office Books.
31. See to the Branch Returns being duly certified and properly incorporated.
32. Check the General Ledger Balances into the Balance Sheet and Profit and Loss Account.

Points to be Remembered

1. Scrutinise the system of Internal Check before formulating your programme of checking.
2. Attend on the last day of the financial period to count and weigh the cash balance on hand.
3. Test a few of the Pass Book Balances with their corresponding Ledger Accounts.
4. It should be ascertained that Pass Books are examined and initialled by some responsible official at least once in every six months.
5. See that all losses or gains on transactions in Foreign Currencies are duly brought in.
6. See that Loans Fully Secured, Partly Secured and Unsecured are clearly shown in the Balance Sheet under appropriate heads.
7. Loans to Directors and Officers of the Bank are to be specifically stated.
8. Obtain Schedules of all Investments showing book values as also the market values.
9. Special precautions should be taken to see that the same securities are not produced twice.
10. It should be seen that the market values of securities deposited against Loans and Overdrafts leave sufficient margin to cover the advances.
11. Scrutinise very closely exceptionally large loans.
12. Investments held for Safe Custody and Collection of Dividends should be examined in sufficient quantities by way of tests.
13. It should be seen that all liabilities are duly brought in, that all losses and expenses are provided, that all assets are correctly valued and that all loans are adequately covered.
14. See that interest is not taken credit for on Loans and Advances which appear doubtful of recovery.
15. If there is any Contingent Liability by way of uncalled capital on the Bank's Investments, the fact should be disclosed.
16. See that the requirements of Section 277K of the Companies Act in regard to the maintenance of Reserve Fund and its investment are duly carried out.
17. Particulars of Loans and Advances should be set forth in the Balance Sheet as under:—
 - (1) Debts considered good and in respect of which the Bank is fully secured.
 - (2) Debts considered good secured by the personal liability of one or more parties as under:—

- (a) Debts due on Bills Discounted,
- (b) Debts due on Joint and several Promissory Notes,
- (c) Debts due on Temporary Overdrafts, Cash Credits and Personal Securities, etc.
- (3) Debts due by the Directors or other Officers of the Bank.
- (4) Debts due by the Directors of the Bank jointly with other persons or on securities and considered good, including debts due by Joint Stock Companies guaranteed by their Agents where a Director of the Bank is a Partner or a Director of the Firm of Agents of the borrowing Company, or is a guarantor, and
- (5) Debts considered Doubtful or Bad.

18. See that the Cash Reserve on Time and Demand Liabilities is maintained as required by Section 277L of the Companies Act.

19. The existence of assets written off to "nil" should be verified.

CHAPTER XVII

SPECIMEN EXAMINATION QUESTIONS AND ANSWERS

The Questions set out in this Chapter have been chiefly based on the past Examination Papers of the Institute of Chartered Accountants and the Society of Incorporated Accountants and Auditors of England, as also the G.D.A. and R.A. Examinations held by the Government of India. The solutions given herein are clear, concise and comprehensive, and a careful study of these is sure to train the examinee into answering examination papers. As an examiner of long standing, it has been the Author's experience that a majority of examinees fail to satisfy the examiners not so much for want of knowledge of the subject, but because of failure on their part to express their thoughts tersely, lucidly and to the point. Great care has been taken in the selection of the questions so as to cover the entire ground of Auditing in its varied aspects, and it is hoped that the student who has faithfully read the Text and has studiously gone over the contents of this Chapter will be able to face any examination paper on Advanced Auditing with the fullest confidence and with best chances of success.

Q. 1. *What do you understand by the term "vouching"?*

A. Examining documents in support of the entries made in the books of account is called vouching. Thus, the verification of the entries in the invoice book with the actual inward invoices, the checking of the cash receipts with the counterfoils of the receipt books, the checking of the cash payments with the acknowledgments from the payees, would be instances of vouching. Vouching forms one of the important duties of an auditor and requires great care, skill and intelligence in its performance. The auditor should carefully scrutinise every entry recorded in the subsidiary books with any documentary or other evidence to satisfy himself that the transactions as entered in the books of account are valid, that they are correctly recorded and that there is sufficient evidence to show that they are properly authorised.

Q. 2. *Is it necessary for an auditor to make notes in course of the conduct of an audit? What notes should he make?*

A. It is highly necessary for an auditor to make notes of all important items that he comes across in course of his work. Thus, notes should be made of all missing vouchers, all points of importance which may require elucidation, all items which may have to be remembered at the time of final checking of the Balance Sheet, and all important queries raised by him, their respective answers received and the officials or the persons who gave the necessary explanations and information required.

It is not necessary to make notes of unimportant queries or of minor mistakes discovered, as these ought to be settled or adjusted as he proceeds with his work.

These notes, if properly made, will prove, no doubt, very valuable to an auditor on any future occasion especially when the question of his liability in connection with any work done by him is considered. Such a question may arise after the lapse of a very lengthy period, when the auditor will have forgotten the events that transpired then and, in such a circumstance, the audit note book will be the only reliable evidence to support the auditor's case.

Q. 3. What do you understand by a system of Internal Check and how does an auditor stand in relation thereto ?

A. The term "internal check" represents a system of organization set up with a view to achieve the following:—

- (1) An exhaustive check on all the incomings and outgoings of goods as well as cash;
- (2) The recording of books of account as well as memoranda and statistical books from day to day;
- (3) An accurate record of all business transactions;
- (4) The prevention of fraud and errors; and
- (5) A speedy detection of fraud and errors.

The most important rule in any good system of internal check is to fix definite duties and responsibilities on each member of the staff and to see that the work done by any one person is checked by another. There must also be a definite record of the part played by each assistant, and a thorough linking of the different sections of the business in a manner as would enable the entire business to be worked without any friction.

Where there is a perfect system of internal check in existence, successful fraud cannot be perpetrated without collusion on the part of two or more members of the staff, and where several members are thus implicated, fraud cannot remain undetected for a long time. The very fact that there is a good system of internal check in existence will have a great restraining influence on the staff, and it will thus help considerably towards prevention of fraud. Besides, as the books would be written up from day to day and the work of one clerk would be checked by another, any errors that might creep in will soon be detected and rectified.

In a concern where there is a sound system of internal check, the work of the auditor would be considerably facilitated inasmuch as the auditor need not in that case concern himself about checking the transactions in detail, but may devote his energies towards the important parts of the audit and questions of principles. But it would be up to the auditor to find out for himself as to how far he should rely on the system of internal check in force, what particular work he should do and what portion of work he should not. In any case, if his suspicions are aroused in any particular direction, it will become his duty to probe the matter to the bottom. In the absence of any suspicious circumstances, the auditor should devote reasonable care and skill

in the due performance of his duties, and he would be perfectly justified in accepting the explanations and information given to him by trusted officials enjoying responsible positions.

Q. 4. Point out the main advantages of a Continuous Audit over a Balance Sheet Audit.

A. A "Continuous Audit" is one where the auditor's staff is occupied continuously on the audit of accounts the whole year round, or attends at periodical intervals, say monthly or quarterly, and where the audit work is not commenced only at the end of the financial period, as is the case with a Balance Sheet or Periodical Audit.

The advantages of a Continuous Audit are:—

- (1) The checking can be performed in greater detail.
- (2) The work of writing up the accounts is kept up-to-date, as a result of the frequent attendances of the auditor.
- (3) Mistakes can be discovered and rectified at an early date.
- (4) The presentation of Final Accounts is not delayed, as very little work would be left by the auditors to be done at the close of the period.
- (5) The opportunities for fraud are considerably lessened on account of the frequent visits of the auditor.

A Continuous Audit is, however, not without its disadvantages. The chief of these are:—

- (1) Figures may be altered, either inadvertently or fraudulently, after the checking has been done by the auditor.
- (2) It is possible that the thread of the work already performed may be lost, and as a consequence thereof, some entries may pass off unchecked in the books.

These disadvantages can, however, be guarded against by making it a rule that no part of the work performed must be left in loose ends, and the audit clerk should note down in the Audit Note Book the work which he has performed on each occasion, thus helping his own memory, or (in case of his absence) another clerk to continue the work at the right end, at a later date.

Q. 5. When called upon to discover errors resulting in disagreement of a Trial Balance prepared from a set of books, how would you proceed with your work?

A. On the disagreement of a Trial Balance, the following would be the usual procedure to locate the difference:—

- (1) Check the totals of the Trial Balance, and ascertain which way the difference lies and the amount of the difference.
- (2) Check the balances from the Nominal Ledger into the Trial Balance and see that these are entered in the right columns.

(3) Glance through the various accounts in the Nominal Ledger to see that there are no unticked items, either on the debit or on the credit.

(4) See that the periodical postings from the Purchases, Sales, Returns and Bill Books are properly done.

(5) Go through all the subsidiary books to see that no item is left unposted.

(6) See that the opening balances are properly brought forward. *

✓ (7) Check the balances from the Personal Ledgers in the Lists of Debtors and Creditors, and see that their respective totals are duly incorporated in the Trial Balance.

(8) Recast the totals of the Subsidiary Books.

(9) Recast the totals firstly of the Nominal Accounts and then of the Personal Accounts.

(10) If the difference is not yet located, there will be no other alternative but to call over all the postings from the Subsidiary Books into the Ledgers. Even while so doing, it would be advisable to tackle the nominal accounts first.

It needs to be pointed out that throughout the course of this work, the auditor will be on the look-out for transactions exactly of the amount representing the difference.

Q. 6. To what extent should an auditor examine the Petty Cash transactions?

A. The question as to what extent the payments through Petty Cash should be vouched will very much depend on the system on which the Petty Cash is maintained. If the Imprest System is followed, the record of the Petty Cashier would be under the constant supervision of and would be checked by the Cashier, and the chances of defalcations would be reduced to minimum. In any case, the auditor should either vouch all the Petty Cash payments of over a certain amount, say Rs. 5, or Rs. 10, or select certain months and vouch exhaustively all the petty cash transactions of the period selected. If he is satisfied on such verification with the accuracy of the record, he need not go further beyond checking the casts and the analytical postings. A Petty Cash Book with analytical columns will be found most suitable. The Auditor should see that every payment is supported by a voucher, that all vouchers are arranged in order of dates, consecutively numbered and properly filed, and their corresponding numbers are shown against the respective entries in the Petty Cash Book. Where no acknowledgments are available from the payees, the auditor should see that a written authority for payments signed by some responsible official or some partner is obtained. He should check all the imprest payments by the Cashier to the Petty Cashier and verify the balance of Petty Cash by actual count. If there are any I.O.U.'s, he should see that they are duly authorised.

Q. 7. What steps would you take to check Cash Receipts on account of the following :—

- (a) Cash Sales ;
- (b) Interest and Dividends from Investments ;
- (c) Sale of Investments ; and
- (d) Book Debts realised ?

A. (a) Cash Sales.—In large stores, where the daily cash sales are numerous, the auditor should first ascertain if there is a proper system of internal check in force and if the rules thereunder are being rigidly enforced. He should then check the daily totals of the Receiving Cashier's Book with the Salesmen's Summaries of the daily sales, and also see that the total cash sales of the day are duly incorporated in the General Cash Book. In the absence of any sound internal check, the auditor should draw the attention of the proprietors or the directors to the chances of fraud in this direction, and should insist upon the introduction of a suitable system of control. If his suggestions are ignored by the proprietors, he should disclaim his own liability in this connection. In case of a company audit, it would become his duty to invite the attention of the shareholders to such an undesirable state of affairs, in his Report.

(b) Interest and Dividends from Investments.—Where there is a large variety of investments, the auditor should call for the Investment Register or Ledger and see that all periodical interest and dividends as shown therein are regularly accounted for, in the Cash Book. The dividends received can further be checked with the counterfoils of the Dividend Warrants received. In case of gilt-edged securities, any interest accrued and not received to the close of the financial period should be brought into account.

(c) Sale of Investments.—The proceeds will be vouched with the Broker's Sold note. In case of *cum div.* sale, it should be seen that proper allocation is made between capital and revenue.

(d) Book Debts realised.—The amounts received from customers would be checked with the counterfoils of the receipts issued. It should be seen that cash discounts, if any, allowed are within the usual limit. In case of an abnormal amount of discount or allowance, the auditor should satisfy himself by further enquiry and explanation from some one in authority. In case of any debt written off as bad, the auditor should see that a proper voucher authorising the entry is produced to him.

Q. 8. In auditing the accounts of a large trading concern, what steps would you take to verify the transactions appertaining to Credit Purchases ?

A. Assuming that there is a reliable system in force for authorising the purchases and for checking the incomings of goods with the invoices, and that

the rates, and calculations of the Invoices are duly checked by responsible clerks, the duties of the auditor in verification of the Credit Purchase transactions will be as under:—

(1) He should check the Invoices with the entries in the Purchases Book, and in case of a Columnar Purchases Book, he should see that the amounts are entered in the appropriate columns.

(2) While examining the Invoices, particular attention should be paid to the following:—

(a) See that the date, the name of the supplier and the amount are correctly entered;

(b) that the Invoices are addressed to the client concerned;

(c) that the goods charged for are usually dealt in by the concern;

(d) that Invoices relating to Capital Expenditure are not wrongly entered in the Purchases Book;

(e) that the Invoices are duly initialled by the responsible official who has checked the prices, by the clerk who has checked the calculations and extensions, as also by those who certify the actual receipt of goods.

(3) The postings of the periodical totals of the Invoice Book should be checked into the Impersonal Ledger and of the individual credits to the accounts of the suppliers in the Creditors' Ledger.

(4) See that the Returns Outwards are duly dealt with.

(5) See that all goods taken in stock have been entered in the Purchases Book.

(6) Ascertain that the payments to the creditors are duly authorised, after their respective statements are checked with the Ledger Accounts and certified as correct by some responsible person.

(7) A good check on the list of Creditors at end may be obtained by asking for statements from creditors indicating the balances due to them at the date of Balance Sheet, and checking the same with the Ledger Accounts.

(8) The auditor should also make sure that goods received on consignment, if any, are not entered as purchases.

Q. 9. *State what steps you would suggest for the proper organization of Wage Records and the payment of Wages in a large manufacturing concern. To what extent would you check the item of Wages, under such a circumstance?*

A. For a proper system as to the preparation of wages sheets and the payment of wages in a large manufacturing concern, the following procedure may be suggested:—

(1) There must be a Register of Workmen wherein the full history of each workman and the terms of his employment should be entered up, and each worker should be known by a number.

(2) Each workman's time of entering and leaving the works should be punched by the worker himself on a card by means of a time-recording clock installed at the entrance of the Factory.

(3) The foreman of each department or shop must also keep a daily record of the men who worked under him.

(4) The two independent records may then be compared at the end of each week or month in order to ensure that no payment is made to any workman for the period he has not worked. A good check will thus be maintained on the time-workers.

(5) Each worker should also be supplied with a Daily Wage Card on which he should enter up the time put in by him and the job number on which he worked, at the end of the day, such entry being initialled by his foreman.

(6) The piece-workers should also enter up their Job Cards from day to day and have their entries initialled by the viewers, thus certifying the quantity and quality of the work turned out and delivered by them.

(7) The above records will form the basis for the preparation of the Wages Sheets, which work should be distributed over as many clerks as possible in order to prevent collusion.

(8) The Wages Sheets should embody a complete record as to the number of each worker, the number of hours he worked (in case of time-workers), the quantity of work done (in case of piece-workers), the capacity in which he was employed, the job or the process on which he worked, the rate of wages per hour, or per day, or per so much quantity of work done, the gross earnings, deductions for advances, fines or contribution to any fund, and the net amount payable.

(9) The work done by one set of clerks should be checked by another set, so that any existing errors may be detected and set right.

(10) Each person should put his initials on the wages sheets, indicating the nature of the work performed by him, or the checking done by him.

(11) The wages sheets as a whole should then be countersigned by the Works Manager as an evidence of their authenticity.

(12) One cheque should be drawn for the total wages due for the week or the month, and the workmen should be paid in the presence of their respective foremen.

(13) Wages of an absentee should not be paid to any other person, except on production of a written authority.

(14) The Wage Cards and the Job Cards will help towards the allocation of wages for the purposes of Costs.

Assuming that the system as above suggested is maintained, the auditor should see that the wages sheets bear on the face of them the signatures or initials of the parties concerned, and should compare the periodical total as shown by the Wages Sheets with the amount of the cheque drawn as appearing on the payments side of the Cash Book. Beyond this, he is not supposed to go, unless there is anything to arouse his suspicions, in which case, he should make full inquiries into the matter. If there is any loophole for fraud or errors in the existing system, it is his duty to point out the same to his clients.

Q. 10. *As an auditor, how would you satisfy yourself that the following have been duly provided for :—*

- (a) *Reserve for Doubtful Debts ;*
- (b) *Outstanding Liabilities for Expenses ; and*
- (c) *Provision for Depreciation ?*

A. (a) *Reserve for Doubtful Debts.*—In order to satisfy himself as to the adequacy of the Reserve for Doubtful Debts, the auditor should look into the following points:—

- (a) The term of credit allowed by the business, and how far any debt has exceeded such limit;
- (b) Whether the balance on any personal account is steadily on the increase;
- (c) Whether there are any accounts with old balances, and if so, what instalments have been received during the period under audit;
- (d) Whether there are any accounts with notes as to bankruptcy, suspension of payments, or of the account having been placed in the hands of solicitors;
- (e) The auditor should have a List of Doubtful Debts prepared and certified by some responsible official and then ascertain how far the total Provision for Doubtful Debts compares with the total of this List;
- (f) He should look into his own notes to see if any balances which seem to him as doubtful have not been included in the List of Doubtful Debts produced to him;
- (g) The above steps will sufficiently give him an idea as to the adequacy of the Reserve or otherwise; and
- (h) If he finds the existing Reserve insufficient, he should have the accounts modified accordingly. If those in management refuse to do so, he should clearly specify the fact in his report or certificate.

(b) *Outstanding Liabilities for Expenses.*—The auditor should certainly ascertain that all expenses incurred and relating to the period under review but not paid, such as Solicitors' Bills for Legal Costs, Interest on Loans, Audit Fee,

Stationery and Printing Bills, Bills for Gas or Electricity consumed, etc., are brought into account. Similarly, all wages, salaries, rent and taxes, commission, advertisements, etc., due should be brought in. A careful scrutiny of the payments side of the Cash Book for the commencement of the succeeding period will give him information as to what expenses were outstanding at the end of the last period. His notes will also inform him as to upto what date the last payments on account of the above expenses were made. For his own protection, the auditor would do well to obtain a certificate from someone in authority that there are no expenses incurred within the period covered by the audit over and above those appearing in the books.

(c) **Provision for Depreciation.**—The auditor should see that each fixed asset appears at cost price less a reasonable amount of depreciation which, if provided for regularly year after year, would bring that asset account to nil or break-up value at the end of its working life. As to what percentage should be written off each year will depend on the class of the asset, the use that is made of the asset and several other factors. The auditor should leave this matter for the decision of experts or those in management, but if he finds that the provision in respect of depreciation of any asset is insufficient, he should not fail to point this out to his client, and in case of a company audit, he should set out the fact in his report to the shareholders.

Q. 11. *How would you verify the item and satisfy yourself as to the proper valuation of closing stock in the following cases :—*

- (a) *Stock of Goods on hand in a Trading Concern ;*
- (b) *Work-in-process of Manufacture ; and*
- (c) *Finished Products ?*

A. (a) **Stock-in-trade of a Trading Concern.**—The valuation of stock-in-trade should be made on the basis of cost or market price whichever is the lower. In no case should it be valued at above cost. The only exceptions to this rule, are in case of the Timber and Wine Trades where the stock appreciates in value, from year to year, as it matures.

The auditor should see that the basis of valuation is consistent from year to year, and must ask for duly certified stock sheets. He may compare the percentage of gross profit on the cost of the goods sold with the percentage as earned in the previous period, and obtain satisfactory explanation in case there is any violent fluctuation. He may compare a few important items from the stock sheets with their respective accounts in the Stock Ledger, if any is maintained, to see if the quantities tally. As to prices, he may check a few items from the Inventories with the actual invoices from the suppliers. Lastly, he may have the casts of the stock sheets taken and see that there is no apparent irregularity in the take, pricing and calculations of the stock inventory.

(b) Work-in-process of Manufacture

(1) The sheets of the work-in-progress should be seen to ascertain the basis of valuation;

(2) It should be seen that the "oncost" allocation is made on some reasonable basis;

(3) That the "oncost" allocation does not include anything in respect of selling or administration expenses; and

(4) That such valuation is duly certified by the Works Engineer and the Works Manager.

(c) Finished Products

(1) Where proper Cost Accounts are maintained, the auditor should inspect these to ascertain how the cost of manufacture of the Finished Products is arrived at; a reasonable percentage in respect of office oncost is usually allowed;

(2) No profits should be added to the actual cost in valuing the finished products for the purpose of financial accounts;

(3) In no case should the value taken be in excess of the price at which similar stock can be purchased in the market;

(4) He should obtain a certificate from the Works and General Managers clearly indicating how the finished products have been valued. If the auditor is dissatisfied with the mode of valuation, his first duty would be to discuss the matter with the proprietors or those in management, and if the accounts are not modified as per his requirements by those responsible, he should qualify his certificate at the foot of the Balance Sheet accordingly, or mention the point in a separate report to the shareholders.

Q. 12. What is the object of "Verification of Assets", and how far is an auditor responsible as regards their valuation?

A. The object of "Verification of Assets" by an auditor is to enable him to ascertain their existence at the date of the Balance Sheet. Whereas the vouchers evidencing the payments in regard to assets will prove that they were acquired by the business, it does not follow that those assets were actually in the possession of that business at the date of the Balance Sheet. Some of them may have been disposed of or charged in any way, and the fact may not have been disclosed in the books. The object of verification by the auditor is thus not only to ascertain as to what assets were acquired, but also to detect the subsequent disposal of any of them with intent to defraud and without recording the transactions in the books of account. If such a verification is not done, the auditor cannot confidently say that the assets as disclosed in the Balance Sheet really existed at that date.

Generally speaking, an auditor cannot be held responsible for the value set against the assets appearing in a Balance Sheet, provided he takes sufficient

care to see that such valuation is made on principles accepted by businessmen as sound and correct, and as are generally followed by similar business. Much will depend on the nature of the business and the class to which the assets belong. The principles generally recognised as correct for the purpose of valuing assets may be stated briefly as under:

Fixed Assets, which are of a permanent character and by means of which the business is carried on, are valued at cost price *less* such depreciation as they may be deemed to have undergone on account of the use they are subjected to for the purpose of earning income. As they are not acquired for re-sale or subsequent conversion into cash, their value to the business will not be affected by market fluctuations, and therefore, they need not be brought down to market value, if the same happens to be lower than the book value.

Floating or Circulating Assets, which are either acquired for the purpose of re-sale or which arise in the ordinary course of business dealings and which must necessarily be converted into cash at the first opportunity, are valued at cost price or market price whichever is the lower, at the date of the Balance Sheet.

In no case, however, should any assets, fixed or floating, be valued at anything above cost.

The auditor should at least make inquiries and ascertain the basis on which the assets are valued, and in case he is not thoroughly satisfied with the value as set against any particular assets, he must disclose such fact to his clients. He should, however, resort to this step only after the refusal on the part of those rendering accounts to modify the same as he wants them to.

Q. 13. *What transactions would you expect to be recorded in a Journal and how would you vouch the various entries therein?*

A. In modern accounting, the use of the Journal is very much restricted to recording transactions as cannot conveniently be passed through any other subsidiary books. The Journal entries would thus consist of opening, adjustment, rectification, transfer and closing entries. There would also be entries relating to issue of share capital and debentures, consignments, joint-ventures, etc. While vouching the Journal, the auditor should see that every entry has a narration clearly indicating its nature and is supported by a proper voucher in one form or another. This may be either a document or a letter or record in a Minute Book. In case of entries like Bad Debts, Allowances, Reserve for Doubtful Debts, Provision for Depreciation, etc., the voucher must take the form of a written authority by some responsible person. As to consignments and joint-ventures, the entries will have to be vouched with the Account Sales and periodical Statements received from the consignees and others.

As the Journal contains a record of transactions as would vitally affect the preparation of Final Accounts and the resulting profit or loss from the business, it follows that the vouching of this Book must receive the greatest care at the hands of the auditor.

Q. 14. *While examining the closing list of Debtors and Creditors with the Ledger Accounts for the purpose of a Balance Sheet, to what points would you pay particular attention?*

A. In regard to the Debtors' balances, enquiries should be made to ascertain if any statements have been sent by the client and confirmation of balances have been received. The statements are useful in two respects. Firstly, they prove the correctness of the balances shown in the books when confirmations are received; and secondly, they act as a gentle reminder to the debtors that the debt is either due or overdue.

Besides the above precaution, an auditor must, while going through each Ledger Account of a Debtor, look into the following points:—

- (1) The term of credit allowed by the business.
- (2) The length for which the debt has been outstanding.
- (3) Whether advantage is taken of cash discount, and settlement made within the term of credit.
- (4) Whether payments are made on account so as to increase the balance every time.
- (5) Whether any arrangement has been made whereby old balance is to be paid off by instalments, and new goods are supplied for cash.
- (6) Whether at any time, bills or cheques have been dishonoured by the party.
- (7) Whether any notes have been made on the Ledger Accounts relating to Bankruptcies, Receiverships, Suspension of Payments, Liquidations or of the placing of accounts in the hands of Solicitors or Debt Collectors.
- (8) Whether there is any unusual item of discount or allowance.
- (9) Debts of long-standing should be particularly scrutinised.

The above considerations will enable the auditor to decide for himself whether all debts, which ought to be written off as bad, have been written off, and whether sufficient provision has been made for all doubtful debts.

As regards Creditors, a comparison of their Ledger Balances with the statements as received from them will prove the accuracy of the balances. If any balance has been long outstanding, enquiry should be made as to why it is so, or whether there is any dispute regarding the balance, or whether there is any suit pending against the client, in which case, a reserve will have to be made.

The auditor must insist upon statements in detail being sent to the customers, as the same may go to reveal any fraud on the part of any member of the staff. The work of sending out statements must be deputed to someone who has no hand in the writing up of that particular Ledger. Other errors which may be disclosed are that the receipts may have been split up or held back for some time.

Q. 15. Describe shortly the *efficient audit of a* ~~work involved in a complete and~~

care to see that such valuation is made ~~work involved in a complete and~~ as sound and ~~correct~~ *Cash Book of a Manufacturing Concern.*

A. The auditor must take the following steps while examining the 'Cash Book of a manufacturing concern:—

Vouching of Cash Receipts

(1) He should first examine the system of Internal Check, if any, existing, before proceeding with his work.

(2) Where counterfoil receipt books are used, he should see that all amounts received from customers are acknowledged through this book and all such counterfoils are duly initialled by the cashier and some responsible official. All receipt forms must bear printed consecutive numbers.

(3) Each receipt as appearing from the counterfoil should be traced into the cash book, and it should be noted that no counterfoil is missing.

(4) All cancellations or alterations of amounts or names on counterfoils should be duly initialled by someone in authority.

(5) All cash sales must be evidenced by Cash Memos, and the latter should be checked into the Cash Sales Summary Book. The daily total of the Cash Sales should then be traced into the General Cash Book.

(6) Cancelled Receipts should not be destroyed or removed from the Receipt Books, but should be initialled as cancelled and pasted on to their respective counterfoils.

(7) Cash receipts from other sources representing neither moneys recovered from customers nor cash sales, will be vouched with other documentary evidence. These will be Interest or Dividends on Investments, unpaid wages, amounts realised on sale of discarded plant, fixtures, etc.

Vouching of Cash Payments

(1) He should see that all payments are supported by proper vouchers which are numbered and filed in order of their entries in the Cash Book. The number of each voucher must be entered against its corresponding entry in the Cash Book so as to facilitate reference.

(2) It should be seen that the payments relate to the business, and the vouchers are made out in the name of the client. If any voucher is addressed to the manager or a director, the auditor should refuse to pass it unless some satisfactory explanation is forthcoming in regard to the same.

(3) All vouchers must be passed before payment by some authorised person.

(4) All cash purchases must be supported by Cash Memos. Payments for credit purchases must be vouched with receipts from suppliers as also Invoices. These may again be checked with monthly or periodical statements received from creditors.

(5) As to wages, enquiries should be made to ascertain that there is a proper check on the recording of workmen's time, the preparation of wages sheets and the payment of wages.

(6) The amount of cheque drawn for the total weekly or monthly wages must tally with the total as indicated by the corresponding Wages Sheets.

(7) The Wages Sheets will be examined to see that they bear the initials of all those who had anything to do with their preparation or checking, and they are countersigned by the Works and General Managers and the Cashier.

(8) All other payments must be corroborated by satisfactory documentary evidence. Thus, the Purchase of Land and Building will be vouched with Title Deeds as also the Directors' Minute sanctioning such transaction, Purchase of Investments with the Broker's Bought Notes, etc.

(9) All payments into and withdrawals from the Bank must be checked in detail with the Pass Book, and the Reconciliation Statement must be duly verified.

(10) He should inspect the Bankers' Certificate as to the balance of the Company's cash with them at the end of the financial period.

Q. 16. *On examining the books of a Manufacturing Firm, you find that entries relating to four Invoices in the Purchases Book under date 25th October have been cancelled and subsequently recorded under date 5th November in the books of the succeeding period. The financial year of the company ends with 31st October. State what such a circumstance would suggest to you and what inquiries you would make to satisfy yourself that the cancellation of the entries is correct.*

A. Any one of the following reason might account for the cancellation of the entries on the 25th October:—

- (a) That the corresponding goods were received subsequent to the date of the financial close and they were not included in the closing stock;
- (b) That the goods in question although received before the financial close were not unpacked and taken into stock; or
- (c) That the goods were actually received before 31st October and were included in the stock, but the corresponding liability was purposely omitted to be brought into record in order to inflate the company's profits.

In order to ascertain the true facts, the auditor should inspect the Goods Received Book so that the actual date of arrival may be determined. If such goods were received before the 31st October, they must be included in the Stock Inventories and the corresponding Invoices must be brought into record in the year under audit. In case the goods were actually received in the

subsequent period, the entries in regard to the corresponding Invoices as originally made would be deemed to be rightly cancelled.

Q. 17. *A client of yours intends to join an established business as a partner and requests you to investigate the accounts of the firm. Indicate the points to which you would specifically direct your attention.*

A. It will be necessary to ascertain firstly the period which the investigation is to cover. Having done that, the Trading and Profit and Loss Accounts and Balance Sheets of those periods will have to be re-drafted on a uniform basis and in a tabular form to enable a ready comparison of the items between one year and another to be made. The report should refer to all points of importance and interest which come to the knowledge of the Accountant, thus helping his client in arriving at a decision as to whether or not he should complete the negotiations. The proposed terms of partnership must be scrutinised by the Accountant in order to enable him to state whether, according to his own report, he considers them reasonable or otherwise.

The reason for the Firm wishing to introduce a new partner should be made the subject-matter of the Report, as this may reveal the financial weakness of the business involving any of the existing partners. It should also be stated whether or not the additional capital is or is not likely to be profitably employed.

Enquiries should be made to ascertain if there are any existing contracts likely to be worked at a loss.

The Report should state the basis upon which the various assets of the firm are valued, and should specifically mention such cases where assets are over-valued, as such a procedure tends to inflate the capitals of the existing partners, and may work to the detriment of the incoming partner in the event of dissolution.

The question of Outstanding Liabilities and adjustments in regard to Bad Debts, Reserve for Doubtful Debts and Depreciation should be enquired into from year to year.

It is necessary to examine in rather greater detail the accounts of the last year of the period, as this may involve manipulations with a view to inflate the profits of that period. Special attention is required to be given to the valuation of closing stock, and to the figures of Purchases and Sales of that period. It should be seen to what extent these differ from their respective figures in previous years. Fictitious sales, over-valuation of stock, omission of liabilities in respect of purchases and expenses are the methods likely to be employed, and such matters should receive close scrutiny at the hands of the accountant. A thorough checking of these items, especially referring the Goods Inward Book and Goods Outward Book for purchases

and sales at the end, becomes essential. A comparison of the percentage of gross profit on turnover for the last year with those of the previous periods will reveal any violent fluctuation.

Q. 18. *State briefly how, in your opinion, the undermentioned assets should be valued in the Accounts you are asked to certify :—*

- (a) *Trade-Marks*, (b) *Loose Tools*, (c) *Consignments*,
(d) *Suspense Account (Removal Expenses)*.

A. (a) *Trade-Marks*.—These should be brought in at cost and revalued from time to time. If they are new Trade-Marks, the cost is made up of expenditure on designs, registration fees, etc. If, however, the trade-marks have been acquired by purchase, the consideration paid would be regarded as the cost, less any amounts written off for depreciation.

(b) *Loose Tools*.—Revaluation is the only satisfactory method which can be applied to this asset, as it is subject to rapid depreciation and to loss by pilfering. The basis of valuation should be cost or market price, whichever is the lower.

(c) *Consignments*.—These should be valued at cost which, for this purpose, would represent the original cost of the goods sent out together with expenses incurred while sending out the same. If, however, the market price of such goods is lower than the cost, it is preferable to value the same at the lower figure.

(d) *Suspense Account (Removal Expenses)*.—This may be treated as Deferred Revenue Expenditure, if it is not desired to write it off in its entirety to Profit and Loss Account. The expenditure should be written off as quickly as possible, since it does not represent a tangible asset of the business.

Q. 19. *On auditing the books of a firm, you find that no Bill transactions are recorded in the Firm's Books until the Bills have matured. Give your opinion on this matter, and show how it would affect the Balance Sheet of the firm.*

A. The method of making no record of Bill transactions until the Bills have matured is essentially unsound, as no record is available to show at any given date the Bills Receivable that are in hand, the dates they become due and whether they have been placed in the hands of Bankers for collection. Further, the parties from whom the Bills were received will presumably not be credited until the Bills are honoured, which is incorrect. As Bills Receivable are negotiable instruments, the absence of any record until the same have matured would materially facilitate fraudulent dealings in regard to the Bills.

In the case of Bills Payable, no record will appear of the outstanding liability in respect of Bills accepted and not yet matured, or the dates when

they will become payable, and the creditors' accounts will not be credited with the Acceptances, until the same are met.

The effect on the Balance Sheet of the firm would be that the item "Sundry Debtors" would appear larger than would be the case had the Bills Receivable been brought into account as received, and no item would appear in the Balance Sheet as an asset under the heading "Bills Receivable".

In the case of Bills Payable, the item "Sundry Creditors" would appear larger than would have been the case had the Bills Payable been brought into account, and no liability in respect of Bills Payable will be shown.

Q. 20. *What clauses appertaining to Accounts would you have inserted in a Partnership Deed, when called upon to advise?*

A. Among other things, a Partnership Deed must necessarily contain the following provisions relating to Accounts:—

- (1) The amount to be contributed by each partner as his capital.
- (2) The extent to which each partner is to be allowed to withdraw sums in anticipation of profits.
- (3) How the profits or losses are to be divided.
- (4) If any interest is to be allowed on the capital of each partner and the rate per cent.
- (5) The rate of interest, if any, to be charged on the drawings.
- (6) If any partner is to be allowed any salary.
- (7) How further capital, if necessary, is to be introduced.
- (8) Provision in regard to amounts to be brought in by any of the partners by way of loans and the interest thereon.
- (9) For all partnership transactions to be duly recorded in a proper set of books to be kept at the place of business and such books to be open to inspection of every partner or his representative.
- (10) That the accounts of the firm be prepared annually and after being duly audited by professional auditors, the firm's Balance Sheet be signed by all the partners as evidence of their acceptance.
- (11) The basis on which to determine the amount payable to a retiring partner or the representatives of a deceased partner in respect of capital and accrued profits since the last accounts.
- (12) The basis of valuation of the goodwill of the firm, if any, as also the other assets, for the above purpose.

Q. 21. *You are called upon to audit the books of a business where only a Cash Book and a Day Book are maintained with all the vouchers and invoices available. How would you proceed with your work?*

A. As there is no suggestion to convert the single entry books into double entry by opening the necessary Personal and Impersonal Accounts and by analysing the receipts and payments as entered in the Cash Book, the auditor would simply construct a Statement of Affairs indicating the position of the firm as at the date fixed by the client, after verifying the transactions as already recorded.

(1) The audit of the firm's accounts will therefore involve the vouching of the cash receipts and payments chiefly with a view to ascertainment of information as to what credit sales have been recovered and what amount stands to be recovered from customers at the end of the period, and what credit purchases have been paid for and what remain outstanding.

(2) The outstanding Book Debts would be ascertained by marking off the cash received from customers as shown by the Cash Book against their respective sale entries in the Day Book. The items left out unmarked will then represent book debts at the close.

(3) The receipts for payments to suppliers, after being checked with the Cash Book entries, will be attached to their corresponding Invoices, which would help to ascertain the Invoices against which payments have yet to be made.

(4) While vouching the receipts side of the Cash Book, it should be ascertained if any fresh capital has been brought in or loans borrowed. Loans not repaid will have to be shown as a liability. The question of interest outstanding on such loans should not be lost sight of. It should also be seen if any amount has been received on sale of any discarded asset.

(5) On vouching the payments side of the Cash Book, notes should be made of the withdrawals by the proprietors and what payments have been made, if any, on account of purchase of fixed assets or investments.

(6) The Cash Book will have to be checked with the Bank Pass Book and a Reconciliation Statement will have to be prepared. A certificate of balance should be obtained from the bankers.

(7) Enquiries should be made if any Bills Receivable or Bills Payable are outstanding.

(8) A proper Inventory of Stock-in-Trade and Furniture and Fixtures will have to be made and the same duly valued and signed by the proprietors.

(9) A list of all outstanding liabilities for expenses incurred and belonging to the period and not paid will have to be signed by the proprietors. A similar list will also have to be prepared for prepaid expenses.

(10) The information obtained on verification on the above lines will help towards the preparation of a Statement of Affairs in which all the assets and liabilities as ascertained will be set out under their appropriate heads. The difference between the assets and liabilities will represent the Proprietors' Capital at that date.

It would not be out of place on the part of the auditor to draw the attention of his client towards this most unsatisfactory way of maintaining business records and to suggest the books being kept in the future on Double Entry principles.

Q. 22. *You are asked to investigate into the reasons for a considerable fall in the trading profits of a manufacturing concern for a particular year, although the sales of that year are well on a level with those of the preceding year. What line of procedure will your investigation take?*

A. A considerable reduction in the trading profits of a manufacturing concern for a year, in which the sales have equalled those of the preceding year, may be due to any one or more of the following reasons:—

- (a) Although the sales may have equalled in amount to those of the previous period, if the quantity sold shows an excess, this will indicate a fall in sale price of the products;
- (b) The purchase price of raw materials may have gone up;
- (c) There might have been a rise in the rates of direct charges, such as freight, duty, etc.;
- (d) The rates of wages may have gone up in the period under investigation;
- (e) The closing stock may have been valued at market price which might be below cost;
- (f) The closing stock may have been under-valued due to omission of some of the items or other errors;
- (g) There might have been pilferings in stock, or goods sold may not have been entered up in the Sales Book.

In order to ascertain the specific reasons for the fall, therefore, an auditor will have to proceed as follows:—

(1) He should ascertain the total quantities sold from the Stock Ledgers in order to find out how the quantities sold in the last year compare with those of the immediate preceding year.

(2) He should compare the Invoices of raw materials of the period under review with similar invoices of the previous period, in order to ascertain whether there has been any increase in the purchase price.

(3) Bills in regard to freight, duty, etc., should be similarly compared to find out if there has been any increase in rates.

(4) Wages Sheets will also have to be compared to determine if the wages of the different classes of workmen have gone up to any extent during the period under investigation.

(5) The System of Internal Check should be most critically examined to ascertain if there are any loop-holes for fraud or pilferings, and in case of any suspicious circumstances, the matter must be thoroughly looked into.

(6) The Stock Sheets of the period under review must be subjected to a very close examination as to quantities, values and calculations.

(7) A comparative scrutiny of the Stock Sheets of the year in question with those of the preceding year will help considerably to indicate what differences there have been, if any, in the prices of similar items.

(8) The sales of the period will have to be examined to ascertain how far the prices have fallen, if any, on comparison with the previous year's transactions.

The above investigations will serve to disclose the reasons which account for the fall in the trading profits of the firm and will form the subject-matter of the auditor's Investigation Report.

Q. 23. *What steps would you take to verify the sales of a trader ?*

A. In regard to the Cash Sales, these would be vouched from the Cash Memos into the Summary of Daily Cash Sales, the daily total of which would be checked into the Cash Book. The auditor should ascertain what system of internal check there is in use, and should make sure that no Cash Memo Numbers are missing, and that Cancelled Memos are not destroyed, but are attached to their respective counterfoils.

As regards the Credit Sales, the correctness of the entries in the Sales Journal should be verified with the duplicates of the outward invoices. The postings of the Sales Journal would then be checked into the Customers' Ledger. As to whether the auditor should check the whole of the postings of the Sales Journal or satisfy himself by mere "test checks" will depend upon the system of internal check obtaining in this connection. Where the system of Self-balancing Ledgers is in use and the Sales Ledgers are independently balanced, it may not be necessary for the auditor to have the whole of the postings called over.

The system of control over Returns Inwards should also receive the auditor's careful scrutiny.

If there are unusually heavy sales during the last month, it should be ascertained that all such goods have been delivered prior to the close of the financial period, and that none of these have been included in the stock.

It should further be ascertained that goods on sale or return, or sales arising from Inward Consignments are not entered through the Sales Journal. The periodical totals of the Sales Journal should be checked to the credit of Sales Account.

Q. 24. *In a large business, would the system of Self-balancing Ledgers be of any advantage to the auditor ?*

A. In an extensive business where the number of entries in regard to purchases and sales is enormous, the system of Self-balancing Ledgers is uti-

lised with the object of enabling a separate trial balance to be prepared from each Personal Ledger individually, so as to make each Ledger-Keeper responsible for the independent agreement of the Ledgers under his charge. Where such a system is worked under proper control, and where the closing balances on the several adjustment accounts opened in the General Ledger agree with the totals of the separate lists of debtors and creditors as prepared from each Ledger, the auditor need not concern himself with the much too detailed checking of the purchases and sales records. Whereas, under such a circumstance, it may be necessary to verify the entries in the Purchases Book with the original invoices, it may not be deemed necessary to check the whole of the postings, and "short cuts" may be resorted to in this connection.

Similarly, in regard to the sales, a "test check" of a substantial portion the entries in the original records will satisfy the auditor, and as to the postings, whereas it would not seem necessary to check the whole of these in detail, the same may be done in respect of certain selected periods. Where such test checks are followed, some variation in the periods selected from year to year would be necessary.

In any case, the system of Self-balancing of Ledgers must prove a source of great satisfaction to the auditor in the sense that it must surely prove to be a great check on the Personal Ledgers, and where there is a sound system of internal organization, the auditor may safely devote his attention towards enquiring into the more important phase of the transactions rather than waste his time and energy over unnecessary detailed checking.

Q. 25. *How would you define (a) Capital Expenditure, and (b) Revenue Expenditure? As an auditor, how would you deal with Structural Alterations?*

A. All expenses incurred in running a business such as salaries, wages, rent, lighting, stationery, etc., are classed as Revenue Expenditure. Besides, expenses incurred in putting the fixed assets in proper repairs and renewals are also revenue expenses.

Capital Expenditure results either in the acquisition of an asset or an improvement or extension to an existing asset as would result in adding to the earning capacity of that asset either by increasing the output or reducing the cost of production.

Where an amount is expended on an existing asset by way of Structural Alterations, the question as to whether such expenditure should be capitalised or be treated as a revenue charge, will depend on how far such expenditure has helped to add to the earning capacity of the asset in question. To the extent to which it has gone to enhance the earning capacity of the asset, the expenditure should be capitalised, and to the extent to which it has served to maintain the asset at its original working capacity, the same should be treated as a revenue charge.

Q. 26. *What is Deferred Revenue Expenditure? What would be the duty of an auditor in regard to a Deferred Revenue Expenditure item? Give four instances of items which could be classed under this head.*

A. Where any heavy expenditure of a revenue nature is incurred, the benefit of which is likely to extend beyond the financial year in which it takes place, it is usual to allow such an expenditure to be temporarily capitalised and to be spread equally over the numbers of years for which it is anticipated the benefit would be enjoyed by the business. The duty of the auditor in this connection would be to see that the item is legitimately treated as a Deferred Revenue Expenditure item and that the amount is distributed over a reasonable number of years. He should also see that the balance of expenditure not written off is clearly specified on the assets side of the Balance Sheet under its distinct heading so as not to be mistaken for any tangible asset.

The following are the usual instances of Deferred Revenue Expenditure items:—

- (a) Cost of Removal of Business to a more convenient locality.
- (b) Cost of Removal of Works and the incidental expenses incurred in connection with the dismantling, removing and re-erection of plant and machinery.
- (c) Exceptional Repairs of a non-recurring nature by way of overhauling of the entire plant or a section thereof.
- (d) Advertising payment made under a contract extending over a term of years, or an abnormally heavy amount expended on advertisement in any one year in order to popularise a new product.

Q. 27. *How would you satisfy yourself as an auditor to a private firm that all liabilities for the period under audit have been included?*

A. In order to ascertain that all the liabilities to date of Balance Sheet have been properly brought in, the auditor would take the following steps:—

Trade Creditors.—The detailed checking of the entries in the Purchases Journal as also the Returns Outward Book and the postings of the Bought Ledger would depend on the adequacy or otherwise of the system of internal check in use. In any case, a part of the entries should be vouched with the purchase invoices, receipted statements, credit notes, etc.

The list of creditors should be checked with the balances as appearing in the Bought Ledger Accounts and should also be checked with the creditors' statements, if available.

Enquiry should be made to ascertain that all goods received during the period have been entered in the Purchases Journal. The purchase invoices for the succeeding period should also be examined to ascertain that none of them relate to the current financial period.

A comparison of the percentage of gross profits earned with the similar percentage of the preceding period will afford some indication as to the possibility of some of the purchase invoices not having been entered.

Creditors for Expenses.—The accounts of fixed expenses of a revenue nature such as salaries, rent, taxes, electricity, etc., should be scrutinised to see that charges relating to the full period covered by the accounts are included, and that proper provision is made in respect of expenses as have accrued due and have not been paid.

In regard to other expenses, the auditor should make enquiries, and if possible, obtain a statement from those in management to the effect that all the liabilities in respect of expenses and charges attributable to the period under audit have been brought in and any such expenses outstanding at the close of the period have been duly provided for.

Creditors for Loans.—Careful enquiries must be made to ascertain that all liabilities in respect of loans borrowed and accrued interest thereon are brought into account.

Q. 28. *What do you understand by Test Checks in Auditing, and what circumstances would lead you to resort to this method of checking?*

A. By Test Checks are meant Short Cuts resorted to by the auditor in not checking the whole of the transactions of any particular class, but restricting the same to any selected periods. Where the auditor finds that the volume of work involved in vouching every book entry would render the audit unnecessarily cumbersome and lengthy, he may apply "test checks" with a view to curtail detailed vouching. But as to what extent he can do this safely, he should determine with due regard to the method of accounting and the system of internal control in use. While deciding upon this line of action, however, he should not lose sight of the risks involved, for the curtailment of work will not in any way lessen his responsibility.

Q. 29. *What would you do prior to commencing the actual work of audit, upon being appointed an auditor to (a) a Partnership Concern, and (b) to a Limited Company?*

A. In case of partnership audit, the auditor must take care to precisely ascertain whether the work undertaken consists of accountancy work as well as audit, or merely the audit. He must have clearly specified in writing from his client the extent and scope of the work he is called upon to perform and the terms on which such work is undertaken.

In case of a Limited Company, the question of the precise nature of the audit required by the client does not arise, as the rights and duties of an auditor in a Joint-Stock Company are defined by the Companies Act.

The next step on the part of the auditor must be to obtain a complete list of books, whether financial, statistical or memoranda, maintained by the business, and the names of the staff members responsible for writing them up or checking them. He should carefully study the system of accounts obtaining in the business, and enquire what system of internal check in respect to accounts, if any, exists. He will then scrutinise such system to see how far it can be relied upon for the accurate record of the transactions and how far the rules and regulations thereunder are being faithfully followed by the members of the staff. It is only after a thorough study of the working of the internal check that the auditor must determine upon his method of procedure. He must also get information as to the scope of authority conferred upon any of the officials or partners. Further, in a partnership audit, the auditor must obtain a copy of the Partnership Deed, if any, or have a letter signed by all the partners stating the terms on which they have agreed to work.

In a Limited Company, the auditor must see that his own appointment is in order, and ask for a copy of the Memorandum and Articles of Association and note the clauses concerning accounts embodied therein. In case of a new company, he should also ask for a copy of the Prospectus, and in case of any other company, a copy of the last Balance Sheet and the report of the previous auditors, if any. This is important inasmuch as such a report may serve to give him most valuable information on matters appertaining to the previous accounts and the state of the company's affairs.

It will not be out of place to suggest that in order to secure an intelligent idea of the working of the business, the auditor should visit the place where the business operations are carried on so as to acquaint himself with the various technicalities and the peculiar circumstances appertaining to the business in question.

If there happened to be a previous auditor, he must get into personal touch with him and enquire into the cause of his resignation or removal. He should also ascertain from the client the cause of such change.

Q. 30. *In a Limited Company Audit, how would you verify the correctness of the payments on account of the following :—*

- (a) *Purchase of Plant and Machinery ;*
- (b) *Erection of Building under a contract ;*
- (c) *Travellers' Commission and Expenses ;*
- (d) *Staff Salaries ; and*
- (e) *Purchase of Shares ?*

A. (a) *Purchase of Plant and Machinery.*—The Board's Minute authorising the purchase should be seen. The entries regarding the purchases must be verified with the suppliers' invoices, and the payments should be vouched with the acknowledgments from the payees. The auditor should also ascer-

tain that the payments are on account of some new plant acquired and that repairs and renewals are not wrongly capitalised.

(b) **Erection of Building under a contract.**—The Directors' Minute must authorise such an expenditure. The contract with the Builders must be seen as to the total cost agreed upon, the terms of payment, etc. The amounts paid will be vouched with the Architects' Certificates and the Builders' Receipts. The payments in regard to Architects' Fees should also be vouched with their receipts and should be included in the Cost of the Building.

(c) **Travellers' Commission and Expenses.**—The Commission Book should be examined with the various agreements with the travellers to ascertain the basis of calculations. The payments should be vouched with the receipts from the travellers. The expenses must be verified with the statements received from the travellers, and it should be seen that only such expenses are claimed and allowed as they are entitled to under the agreements. All outstanding in respect of unpaid Commission and Expenses due to the end of the financial close should be brought into record, as a liability.

(d) **Staff Salaries.** The respective salaries will be verified with the Salaries Book and the payments will be vouched either with the initials of the receipts in the Salaries Book or separate acknowledgments. Any increase in salary or new appointment should be verified with the Directors' Minute.

(e) **Purchase of Shares.**—This will be verified with the Brokers' Bought Note. If the shares are purchased *cum div.*, the proper allocation between Capital and Revenue must receive the auditor's attention. In case of a new issue, the Allotment Letter and receipts for the instalments paid should be examined. At the time of Balance Sheet Audit, the existence of the securities should be verified by actual inspection, or in case they are lodged with the Bankers, the Bankers' Certificate stating that they held these securities in safe custody at the date of the Balance Sheet should be obtained.

Q. 31. *How should Investments be verified and valued for the purpose of a Company Balance Sheet?*

A. Investments may be represented by Certificates, Bonds, Allotment Letters or Scrip, or they may be in shape of Inscribed Stock.

Except in case of Inscribed Stock, the auditor must actually inspect the securities. He should see that the Certificates are made in the name of the client and are duly signed and sealed. In case these are lodged with Bankers, he should obtain a certificate from them stating that they held the securities in safe custody as at the date of the Balance Sheet, on behalf of the client.

In regard to Bearer Bonds, the auditor should see that all coupons for interest not yet due are attached thereto. In regard to Scrip, he should see

that all instalments of call moneys so far paid by the client are duly acknowledged.

As regards Inscribed Stock, the same can be verified by requesting the Bank in whose books the stock is inscribed to confirm the fact of the stock having been registered in the client's name.

The question as to how Investments should be valued for Balance Sheet purposes must necessarily depend on the object for which they are held. For instance, in case of a Trust Company where the investments are held by way of fixed assets for the purpose of distributing the income arising therefrom amongst its own shareholders, there is no legal obligation on such a concern to provide for depreciation in the value of its investments before arriving at divisible profits. Where, however, as in the case of Finance Companies, the main object is to buy and sell investments or to undertake floatation of companies or underwrite the share capital of companies, such investments would represent their floating assets. In such a circumstance, they should be brought down in value to market price, if the latter happens to be lower than the cost.

In no case, should the auditor allow any appreciation in the value of Investments to be brought into record by the corresponding credit being given to Revenue Account, if their market value happens to be more than the cost.

In case of Banks and Insurance Companies where large Funds are sunk in Investments, as also in the case of Trading and Industrial Concerns where any excess working capital is temporarily invested in gilt-edged and other securities, a safe rule is always to value the Investments at cost or market price, whichever is the lower, and never to bring any appreciation in value into account till the investments are realised.

Q. 32. *What is a Balance Sheet, and how far should an auditor see to the proper grouping of assets and liabilities therein?*

A. A Balance Sheet may be defined as a statement prepared with a view to measure the exact financial condition of a business on a certain fixed date. In order that the true financial state of affairs of any concern may be clearly reflected in its Balance Sheet, it is important for the auditor to see that the assets and liabilities are properly grouped and classified under appropriate headings and that no material fact is suppressed or is presented in a manner as would create a false impression as to the state of affairs in the mind of one reading the Balance Sheet.

As to in what order the various items should appear on the assets and liabilities side of a Balance Sheet, will depend upon whether the Balance Sheet is that of a private firm or of a limited company. In case of a company, the Capital is first set out on the left-hand side and is then followed by liabilities to outsiders. The order is just the reverse in case of Balance

Sheet of a private firm, wherein the outside liabilities are shown first and then are set out the capitals of the proprietors, on the left-hand side. In case of a company, the assets are shown in the order of their permanence, whereas in a private firm, they are arranged in order of their realisability.

The Form of Balance Sheet in a limited company is prescribed by the Companies Act, 1913-36. The various requirements of the Act may be summarised thus: The share capital must be set out in the different classes of shares as also the authorised, issued and subscribed and paid up amounts. Shares issued as fully or partly paid up must be shown separately from shares issued for cash. The various funds must be individually set out so as to indicate clearly their nature. Reserves by way of provisions against loss on specific assets must be deducted from their respective assets on the right-hand side.

Creditors for Loans must be appropriately distinguished between secured and unsecured. In case of secured creditors, the nature of the securities must be clearly specified. Creditors for goods purchased, for expenses outstanding and for bills payable should be distinctly shown under appropriate heads. Interest accrued due on loans secured must be shown under its distinct heading. The last item will be the balance on the Profit and Loss Appropriation Account.

The Contingent Liabilities, if any, should be disclosed by way of a footnote on the liabilities side of the Balance Sheet.

While grouping the assets, distinction must be observed between tangible and intangible assets, and items like Goodwill, Preliminary Expenses, must not be mixed up with Fixed Assets like Building, Plant, etc. Each Fixed Asset must be shown at original cost under its individual head, and depreciation thereon must be shown by way of deduction.

The Floating Assets which will follow will also have to be distinguished one from the other. As to Stock and Investments, their mode of valuation must be clearly disclosed. In case of Book Debts, a distinction must be drawn between good and doubtful debts, as also secured and unsecured. While setting out the Investments, their nature must be clearly indicated, and gilt-edged securities should not be mixed up with investments of a speculative character. Investments in subsidiary companies and debts owing to and by subsidiary companies must be separately shown.

All Fictitious Assets such as Preliminary Expenses, Brokerage on Shares, Discount on Issue of Debentures, etc., should be shown under their distinct heads, so as not to be mistaken for any tangible assets.

The auditor's duty is thus to satisfy himself that the Balance Sheet is drawn upon right lines, and if it lacks in any information, or is misleading in some direction, or if the grouping is so made as to make the position of the business appear better than it really is, it will be his duty to report the fact to the shareholders.

In a partnership firm, the reverse form to the above is generally followed and here again the auditor should see that the Balance Sheet does clearly reflect the true financial conditions of the business in question.

Q. 33. *State briefly how you would verify the following assets in a Limited Company Balance Sheet :—*

- (a) *Freehold Land and Premises ;*
- (b) *Plant and Machinery ; and*
- (c) *Goods on Consignment.*

A. (a) *Freehold Land and Premises.*—The auditor should examine the Title Deeds, and in case of any doubts as to the validity of the title, he may refer the matter to the company's solicitors. If the property has been mortgaged, the title deeds will be in the possession of the mortgagee or his solicitor, and a certificate should in that case be obtained from the parties to that effect.

As regards valuation, the Land may be valued at cost price, but it will become necessary to provide for some reasonable depreciation in regard to the Building. The original cost of this asset can be verified from the deed of conveyance or with reference to the builder's receipts, etc., if the premises were built by the company itself.

(b) *Plant and Machinery.*—In regard to the original purchase of plant, the same would be verified with the invoices received from the manufacturers. Erection charges would be allowed to be capitalised. In case of an old concern, the auditor will require from the chief engineer a certified list of plant and machinery at the date of the balance sheet. In case of any additions during the period under audit, he must satisfy himself to see that these represent some new plant or machinery acquired, and not renewals or replacements wrongly capitalised. Fixed plant is valued at cost price less depreciation, the percentage whereof depends upon the class of machinery and its estimated working life.

(c) *Goods on Consignment.*—This item will represent the balance of unsold goods in regard to outward consignments. The usual mode of valuation would be the cost price of the goods *plus* a proper proportion of all charges incurred by the consignor in respect of these goods. If the market value of these goods has fallen, due allowance must be made in this respect. It is neither desirable nor sound to include a proportion of the expenses incurred by the consignee, while valuing unsold stock of consignment goods.

Q. 34. *Briefly mention the steps an auditor would take to enable him to give the necessary certificate for the purpose of the Statutory Report. Give also the Form of such a Certificate.*

A. In order to enable an auditor to certify the Statutory Report so far as the Statement of the Receipts and Payments is concerned, the following steps would be taken:—

(1) The Company's Memorandum and Articles as also the Prospectus should be carefully studied and notes should be made of items affecting terms of share capital issue, minimum subscription, brokerage on shares or underwriting commission, acquisition of assets and liabilities from vendors, mode of satisfaction of purchase consideration, etc.

(2) It should be seen that the limit, if any, placed on the borrowing powers of the company, is not exceeded.

(3) A complete and exhaustive audit should be made of Share Capital and Debenture Issue, including checking of entries in Register of Members and Register of Debenture-holders.

(4) The auditor should ascertain that the requirements of the Act as to Minimum Subscription has been duly complied with.

(5) A thorough vouching and checking of the Cash Book transactions for the purpose of verifying the Capital Receipts and Payments will be necessary.

(6) In order to ascertain the correct balance of cash in hand and in bank, it would be necessary to include in the checking the revenue receipts and payments also.

(7) The items included in the Preliminary Expenses Account must receive the close scrutiny at the hands of the auditor.

(8) Brokerage on Shares should be carefully vouched to ascertain that such payments are made only to *bona fide* brokers.

(9) Directors' minutes will have to be referred to in order to see that the allotment of shares and debentures is properly done, and that all capital expenditure and loans borrowed are duly sanctioned.

(10) The whole of the receipts and payments should be verified with the Bank Pass Book and the bank balance reconciled.

(11) The Capital Receipts and Payments will have to be shown separately from the revenue items.

The Auditor's Certificate at the foot of the Statement of Receipts and Payments, will take the following form:—

"I hereby certify that so much of this Report as relates to the shares allotted by the Company and to the cash received in respect of such shares and the receipts and payments of the Company is correct."

Auditor.

Q. 35. *Is an Auditor entitled to examine the Minute Book of a Company, and, if so, in respect of what transactions?*

A. As the Minute Book is a Statutory Book to be maintained by all companies, and as items of vital importance relating to the decisions and resolutions of the Directors on matters of finance and accounts would be

recorded therein, the auditor must carefully go through the same. It is desirable to have two separate Minute Books, one to record the proceedings of the Directors, and the other, to record the resolutions of the Shareholders.

Reference to the Directors' Minute Book would be necessary in regard to the following matters:—

- (a) Appointment and Remuneration of Secretary, and Managing Directors and other officials;
- (b) Adoption of Contracts with Vendors and others;
- (c) The issue and allotment of Shares and Debentures;
- (d) Calls made on the Shareholders and Debenture-holders;
- (e) Authorisation of Capital Expenditure;
- (f) Forfeiture of Shares;
- (g) Declaration of Interim Dividend, etc.

The Shareholders' Minute Book will have to be referred to in respect of the following:—

- (1) Passing and adoption of accounts;
- (2) Sanctioning appropriation of Profits;
- (3) Appointment and remuneration of Directors and Auditors;
- (4) Alterations of Articles, etc.

The auditor cannot be refused access to the Minute Books, and if the Directors refuse him the inspection of the same, he must report the matter to the shareholders.

Q. 36. *Explain what you understand by "Debentures issued as a Collateral Security for a Loan". How would you show such a transaction in the Company's Balance Sheet?*

A. The term "Collateral Security" means a security accompanying but subordinate and which can be realised by the holder thereof, in the event of failure on the part of the company to repay the original Loan in respect of which such security was given. As soon as the loan is repaid, the Collateral Security is automatically released. When Debentures are issued as a Collateral Security, the fact should be distinctly disclosed in the Balance Sheet by way of a note underneath the item of Loan against which they are so issued.

Q. 37. *As Auditor of a Company you find that, during the year under audit, large sums have been expended in repairs, alterations and improvements to existing plant. What principles would guide you in arriving at a correct allocation between Capital and Revenue?*

A. While vouching the amounts expended with the original invoices, care should be taken to ascertain as to what they really represent. If it is found on such examination that the amounts relate to repairs and replace-

ments of worn-out parts which merely serve to maintain the machinery in its original working efficiency, they should be charged off in their entirety to revenue. If, however, the amounts thus spent are abnormally heavy and of a non-recurring nature, the burden in this respect may be distributed over a period of 3 to 5 years as are likely to receive the benefit of such expenditure, and a proportionate amount only would be charged to the Revenue Account of each of these years.

All amounts expended in shape of improvements to machinery as would result in actually increasing the earning capacity of the same, either by turning out larger output or by reducing the cost, should be capitalised.

As to the alterations, to the extent to which they help to maintain the plant in its original working condition, they will be charged to revenue, and to the extent to which they serve to add to the working efficiency or revenue-earning capacity of the plant, they would be capitalised.

It is important to note that the amount expended of itself will not help towards determination of the nature of the charge, for a heavy amount expended does not necessarily signify additions or improvements, nor would a small amount signify always repairs or renewals. The auditor should, therefore, make full inquiries into the matter for the purpose of ascertaining whether the allocation between Capital and Revenue has been made on the right lines.

Q. 38. *A Limited Company which has been in existence for 10 years had acquired a Freehold Property and also a 30 years' Lease immediately after incorporation, and on your being appointed auditor for the first time, you find that both these assets appear in the last Balance Sheet at actual cost. What course would you suggest to be followed before signing the Balance Sheet?*

A. From the facts given, it is evident that no depreciation has been brought into record since the acquisition of both these assets, although ordinarily, fixed assets are deemed to be shown in the balance sheet, year after year, at their original cost less whatever depreciation they may have suffered due to their being utilised in business or due to effluxion of time. A careful auditor would see that such an oversight is set right by bringing into adjustment the accumulated depreciation not written off so far. Freehold Premises would have to be depreciated at an annual rate of 1 to $2\frac{1}{2}\%$, whereas the Leasehold will have to be written off to the extent of $33\frac{1}{3}\%$, as one-third of the period has already expired. It is unfortunate that the tenth year under audit will have to bear the total loss in this respect, but the error will have to be set right just the same. If, however, there are divisible profits brought over from the preceding year as a credit balance on Profit and Loss Appropriation Account, or if there is a Reserve Fund, only the current year's depreciation need be charged to the Profit and Loss Account and that of the previous years may be set off against the undistributed profits, if any, brought

over, or against the Reserve Fund. This is necessary in order that the Profit and Loss Account may reflect the true profit made during the period. If the Directors refuse to provide for any depreciation, the auditor must bring this fact to the knowledge of the shareholders.

Q. 39. *What method would you suggest to enable the Directors of a large manufacturing company to maintain a detailed record of the costly Plant and Machinery, as also to arrive at a fair amount of Depreciation to be charged in the accounts each year?*

A. Where the machinery is costly and varied in character, the best manner of maintaining an exhaustive record thereof would be by means of a Plant Register. The Register should be in form of a Ledger with a separate account for each machine or section of machinery. At the head of each such account, sufficient details as to the name, number and make of the machine will be given. Further details must then be recorded as to the date of acquisition, the original cost price, its estimated working-life and the probable break-up value.

Columns must be provided to record the amounts expended on repairs and renewals and the amount provided for depreciation from year to year.

Such a detailed record will help considerably towards arriving at a fair amount of depreciation to be charged to accounts each year, as different percentages will have to be applied to different sections of machinery and plant. Besides, it would enable those in management to ascertain how the actual facts in regard to the working-life of the machines and their probable break-up value compare with the estimates made. It will further show what amount of repairs and renewals each Machine requires during its working-life.

When any machine is discarded or sold off as scrap, the then book value of such machine can easily be ascertained from this Register, and the difference between this and the amount realised will have to be transferred from the Plant and Machinery Account to the Profit and Loss Account.

Q. 40. *Having suggested the necessity of providing for Depreciation, the objections raised by the Directors are (a) that the market value of similar machinery at the time of the Balance Sheet is higher than the original cost; (b) that the machinery has been maintained in thorough repairs and is as good as new, and (c) that a similar percentage as written off in good years, if charged this year, will prevent any dividend being declared, and this will considerably affect the market value of shares. How would you meet such arguments?*

A. (a) While holding out the argument that the market value of similar machinery is higher than the original cost, the fact that their machinery has become old and second-hand by continuous use seems to have been overlooked by the Directors. Besides, the rise in market value may be temporary,

and this is not going to realise a corresponding enhanced residual value at the time the machinery will have to be discarded. So far as Plant and Machinery is a fixed asset, the loss sustained by the use of the asset from year to year must be brought into accounts irrespective of market value.

(b) The argument that the machinery is kept in excellent repairs and is therefore as good as new cannot hold good, as experience has proved that no amount of repairs can make machinery last any longer than its normal life. As a matter of fact, the average working-life of any machinery is estimated on the basis of the assumption that it will be constantly maintained in thorough repairs. Repairs are necessary to keep the machinery in excellent working condition, whereas depreciation represents loss in value of the asset due to its being utilised in business. Both these types of losses must therefore be charged to revenue before arriving at the true profits of any year.

(c) It is no argument to say that the provision for depreciation will prevent the directors from declaring a dividend. Directors are not supposed to declare any dividends except out of profits, and in order to ascertain true divisible profits, it is desirable and, in many cases, legally necessary to provide for depreciation.

An auditor cannot compel the directors to write off any depreciation on Fixed Assets, but in case the latter refuse to abide by his opinion, the only remedy left open to him is to either qualify his certificate at the foot of the Balance Sheet accordingly, or to point out the fact to the shareholders in his report.

Q. 41. *A firm of Engineering Contractors desire to take credit for profit on Uncompleted Contracts. Would they be justified in doing so, and how should such profits be estimated?*

A. It may not be theoretically sound to anticipate profits on uncompleted contracts, but in practice, this is generally allowed in case of large Engineering Contractors or Builders, where the contracts often extend over several years. In such a circumstance, if no profits are brought into record till the contracts are completed, there will be wide fluctuations in profits from year to year. Thus, there will be hardly any profit in the year in which very few contracts or no contract would be completed as compared to large amount of profits appearing in the years in which important contracts would be completed.

* The profits on uncompleted contracts should, however, be estimated on the most conservative basis, and ample reserves must be made for all kinds of contingencies likely to arise in the future, as might convert the profit into a loss. As a rule, only three-fourths or two-thirds of the profit ascertained is taken credit for, having due regard to the portion of work already done and the remaining to be done; and in cases where the work done is partly paid for, profits are taken credit for on cash basis, after making ample provision

for all contingencies. What the auditor has to see is that such profits are ascertained on sound and consistent basis.

Q. 42. *How would you define Goodwill, and how should it be valued for Balance Sheet purposes ?*

A. Goodwill may be defined as an extra value attaching to an established business beyond the intrinsic worth of the net assets employed therein, and arising from the trade name, reputation, sound connections, high profit-earning capacity and an expectation that equally profitable conditions will obtain in the future, despite a change in proprietorship. Goodwill should only be brought into record as a paid asset, and once it is so recorded in the books, it is not necessary to adjust its value from year to year, as its exact negotiable value on any one date cannot be determined until it is realised on sale of the business. Even in case of a company, there is no legal obligation to depreciate its value from year to year, unless its Memorandum or the Articles so provide. From the view-point of sound finance, however, the auditor may always advise on the desirability of providing for the future decline in value of goodwill from surplus profits, as no business however profitable can be expected to yield super-profits in perpetuity. In order that the original cost of goodwill may not disappear from the Balance Sheet, the provision in respect of its depreciation may be credited to a separate fund and shown as a deduction from the cost every year. In no case should an auditor allow the value of goodwill to be written up. He should equally disallow the creation of a Goodwill Account by a concern, if his advice is sought in the matter.

Q. 43. *What is a Secret Reserve, and what is an auditor's duty in connection therewith ?*

A. A Secret Reserve is one which is not apparent on the face of a Balance Sheet, with the result that the true financial condition of the business is much better than is disclosed by the Balance Sheet. The object of maintaining such a reserve is to provide a fund which would help the company to meet some unforeseen contingency or heavy loss without disclosing such fact to the shareholders or the competitors of the business.

A secret reserve can be created in any one or more of the following ways:—

- (1) By overstating Outstanding Liabilities;
- (2) By providing for Doubtful Debts, Discounts and Depreciation, more than the legitimate requirements;
- (3) By under-valuing or omitting assets; or
- (4) By changing Capital Expenditure to Revenue.

Where there is a Secret Reserve, the auditor's first duty would be to determine if it is justifiable, with due regard to the nature of the business.

If he finds that the intentions of the directors are honest and in the best interests of the company, he need not disclose the fact to the shareholders. But if the creation of such a Reserve has, at its bottom, undue manipulation of annual working results or speculation by the directors in the shares of the company, the auditor will have to report the fact to the shareholders. Such Reserves are generally maintained by Banks and Finance Companies whose business would depend on their financial standing and credit in the money market, and who cannot afford to pay varying dividends or disclose some abnormal loss in any one year. Even where the Reserve is secret, the fact should be brought to the full knowledge of the auditor, and any regulation in the company's Articles preventing him from having access to the fullest information on this account will be *ultra vires*.

Where large credits are brought into the Profit and Loss Account from Secret Reserves so as to augment the current year's trading results, the auditor would be running considerable risks if he failed to indicate these items clearly on the face of the accounts.

Q. 44. *Having completed the audit of a company's Balance Sheet to your satisfaction, in what form would you give an unqualified Report to the Shareholders?*

A. The form of the report will be as under:—

We have audited the annexed Balance Sheet of.....
Company, Limited, as at.....and also the annexed Profit and
Loss Account of the Company for the year ended on that date, and report that

(a) we have obtained all the information and explanations which we have required;

(b) in our opinion, the annexed Balance Sheet and Profit and Loss Account are drawn up in conformity with the Law;

(c) such Balance Sheet exhibits a true and correct view of the state of the Company's affairs according to the best of our information and explanations given to us and as shown by the Books of the Company; and

(d) in our opinion, books of account have been kept as required by Section 130 of the Indian Companies Act, 1913.

Auditors.

Q. 45. *What steps would you take as an auditor to verify the item "Preliminary Expenses"?*

A. For a proper verification of Preliminary Expenses, an auditor should refer to the contract with the vendors to see whether they have agreed to bear the whole or any part of these, and if so, he must see that the company is not made to bear the expense that ought rightly to be charged to the

vendors. Items debited to Preliminary Expenses Account must be carefully vouched to see that they are properly chargeable to this Account. Preliminary Expenses will generally include the following:—

(1) Stamp duties and fees on the Nominal Capital, and stamps on the preliminary contracts of the company. The amount can be verified by an examination of the certificate of incorporation and the contracts. If paid by the solicitors, the same will appear in their receipted bills of costs.

(2) The legal charges in connection with the preparation of the Prospectus, Memorandum and Articles of Association and Contracts, and of the registration of the company. These will be vouched by reference to the solicitors' receipted bills of costs.

(3) Accountants' and valuers' fees for Reports, Certificates, etc., will be vouched with their bills and receipts.

(4) Cost of printing the Memorandum and Articles of Association and printing, advertising and issue of Prospectus, will be vouched with the printers' and newspaper companies' bills and receipts.

(5) Cost of preparing, printing and stamping Letters of Allotment and providing Share Certificates.

(6) Cost of preparing, printing and stamping Debentures and Debenture Trust Deed (if any).

(7) Cost of company's seal and original books of accounts as well as Statistical and Statutory Books.

The Preliminary Expenses should be shown as a distinct item on the Balance Sheet, and must not include items like underwriting commission or brokerage on issue of shares or debentures, or discount upon debentures, which should be separately shown. They should be written off to revenue over a period of years, usually three to five, although the Act does not compel such writing off, in the absence of any provision to that effect in the Articles. In any case, this being a fictitious item, the sooner it is wiped off the Balance Sheet the better.

Q. 46. *The Directors of a public company have paid Interest on Share Capital during period of construction and have treated the same as capital expenditure by adding to the cost of construction. What special points would you look into before certifying the accounts as correct?*

A. In case of Interest on Capital paid out of Capital during the construction period, the auditor can certify the accounts prepared by the directors, provided the following conditions are fulfilled:—

(1) That such payment is authorised by the Articles of the Company or by Special Resolution;

(2) That the previous sanction of the Local Government is obtained;

(3) That the period for which such payment is made does not exceed that which is sanctioned by the Local Government for such purpose;

(4) That the rate of interest does not exceed four per cent per annum or such lower rate as may for the time being be prescribed; and

(5) That such payment is shown distinctly in the Balance Sheet of the period in which it is made.

The auditor must see that all the above requirements have been duly complied with.

Q. 47. *Should an auditor refer to the company's Memorandum and Articles and, if so, for what purposes?*

A. In course of his duties, an auditor must necessarily consult the company's Memorandum and Articles, particularly on the following points:—

The Memorandum should be seen to ascertain the objects of the company, the authorised share capital and the number and different classes of shares into which it is divided.

The Articles should be referred to in regard to the following:—

(1) The clauses as to the issue of Capital and the rights of the Shareholders *inter se*.

(2) Minimum Subscription.

(3) Underwriting Commission.

(4) Brokerage on Shares.

(5) Number, Remuneration and Qualification of Directors.

(6) Borrowing and other powers of the Board.

(7) Forfeiture of Shares.

(8) Calls in Advance.

(9) Regulations as to Accounts and Audit.

(10) Dividends and Reserves, etc.

Q. 48. *How should the amount received on Forfeited Shares be dealt with in a Company's Books?*

A. In the published accounts of a company, the number of shares forfeited should be shown as a deduction from the number of shares subscribed by the public, and only the amount received on the net number is to be treated as Share Capital amount entitled to dividend. The amount received on shares which are forfeited will follow the item of share capital on the liabilities side of the Balance Sheet, and it will appear there till such shares are re-issued. On the re-issue of such shares, if they are issued at a discount (which latter in no case should exceed the amount previously received), the balance of Forfeited Shares Account—after an amount is transferred to Share Capital Account to cover the discount—will be utilised in writing off fictitious

assets like Goodwill or Preliminary Expenses, Brokerage on Shares or transferred to a Capital Reserve not available for Dividends. In the absence of the Company's Articles to the contrary, there is nothing to prevent a company from utilising the balance left on Forfeited Shares Account after the re-issue of the same shares in distribution as dividend, although the procedure may not be considered as desirable from the view-point of sound accounting or finance.

Q. 49. *When called upon by the Directors of a Company to conduct a periodical Share Transfer Audit, how would you proceed to do your work?*

A. The following will be the course of procedure in respect of the Share Transfer Audit of a company:—

(1) Ascertain whether all transferors have been notified of the lodgment of transfer, and enquire as to whether any objections have been received.

(2) The signatures of the transferors should be compared with those on previous transfers or application forms, and it should be seen that the transfers are duly executed and stamped.

(3) See that each transfer is duly authorised by the Board's Minute.

(4) See that all alterations on Transfer Deeds, if any, are initialled.

(5) The distinctive numbers of the shares should be checked with the transferor's account in the Share Register and with the certificates lodged with the transfer, which should be cancelled.

(6) Where part of a holding is transferred, it is usual to issue Balance Certificates, in which case it should be seen that the distinctive numbers thereon represent the balance of shares not transferred.

(7) The new certificates and balance certificates (if any) should be checked and it should be seen that the counterfoils thereof are correctly entered.

(8) The entries in the Register of Transfers should also be checked.

(9) He should check the entries from the Share Transfer Register into the Register of Members.

(10) It may be pointed out that it is no part of an auditor's duty to examine the Share Transfer Work unless his services are specially engaged for such a purpose.

Q. 50. *In auditing the accounts of a Limited Company, how would you verify the following:—*

(a) *Directors' Fees and Travelling Expenses;*

(b) *Brokerage on Shares; and*

(c) *Unclaimed Dividends?*

A. (a) *Directors' Fees and Travelling Expenses.*—The Company's Articles would be referred to in order to ascertain the manner in which the

remuneration of the Directors is to be calculated and whether they are entitled to Travelling Expenses incurred in attending Board Meetings. The payments will be examined with the vouchers signed by the Directors, and the auditor should see that no payment is beyond what is authorised by the Articles or as voted by the shareholders. If the fees are at so much per each attendance, the auditor should scrutinise the Directors' Attendance Book to see that the entries therein are duly initialled by the Directors. It should be seen that the Travelling Expenses are not unduly excessive, and full details are shown in the statements submitted by the Directors.

(b) **Brokerage on Shares.**—The payment of Underwriting Commission or Brokerage on placing shares will have to be vouched with the authority contained in the Articles as to the amount or rate per cent of the commission, and also with the disclosure in this respect made in the Prospectus or Statement in lieu of Prospectus. The auditor should see the contract with the Underwriters or the endorsements on the Share Application Forms to ascertain that such brokerage is paid only to *bona fide* brokers. The amount thus paid should be shown under its distinct head in the Balance Sheet and must be written off to Revenue by distributing it over a number of years.

(c) **Unclaimed Dividends.**—These will be checked with the credit balance of the Dividend Account, and the item will appear distinctly under its appropriate heading on the liabilities side of the Balance Sheet.

Q. 51. *The Directors of a trading company present to their shareholders a statement of Cash Receipts and Payments, and on the strength of the excess shown thereby, they resolve to distribute the whole of such surplus in dividend. Criticise their action and point out the risk they run in looking upon such excess as profits available for dividend.*

A. It would be absolutely wrong in principle to look upon the excess of cash receipts over cash payments of any particular period as profits made during that period. A statement of Receipts and Payments is not a Profit and Loss Account, and, therefore, any balance at the close as indicated by such a statement does not necessarily represent any profit, but balance of cash in hand or at bank. A cash balance will be no criterion on which to base the profit or loss of a company, and despite the fact that there is a considerable cash balance at the close of the trading period, it cannot safely be said that such a balance represents distributable profits. A large cash balance at the end may be due to an amount realised on the sale of a fixed asset or investments, or a loan borrowed just before the close of the period. A concern may have sustained a trading loss during a given period, and yet the statement of receipts and payments, if made for the same period, may disclose a heavy cash balance due to any one of the reasons stated above, and the payment of a dividend out of this balance may amount to nothing short of payment of dividend out of capital.

Moreover, a Receipts and Payments Statement would include capital receipts and payments, and no account would be taken therein of expenses incurred and remaining unpaid at the close of the financial period and no adjustment in respect of income received in advance or pre-paid expenses.

In order to arrive at the correct figure of profit or loss made during any period, it is necessary to prepare a Profit and Loss Account. While preparing this account, adjustments in respect of Bad and Doubtful Debts, Depreciation, Pre-paid Expenses, and Outstanding and Pre-paid Income, if any, will have to be made. All Outstanding Liabilities in regard to purchases made during the period and expenses incurred and not paid will similarly have to be brought into account. It is then that the correct figure of profit or loss made during the period will be determined, and if the resultant figure discloses a loss and the directors have already declared a dividend and paid the same out of the cash balance, they will be held to be personally liable to the company for such a distribution, because the accounts of the company did not justify such a declaration of dividend.

Q. 52. *Set out in detail the extent to which you would check the issue of the Share Capital in a newly-formed company.*

A. The following steps will be necessary to carry out an exhaustive checking of the Share Capital Issue in a newly-formed company:—

(1) Consult the Company's Memorandum of Association to ascertain the Authorised Capital and the classes of shares into which it is divided. See that the Issued Capital does not exceed the Authorised Capital.

(2) Compare the provisions in the Articles as to Minimum Subscription, Underwriting Commission and Brokerage on Shares with similar statements in the Prospectus or Statement in lieu of Prospectus.

(3) Check the Application Letters with the Share Application and Allotment Book.

(4) See that all Allotments are made subject to the Board's Minute.

(5) Check the cash received on Application and Allotment as shown by the counterfoils of receipts into the Cash Book and thence into the Application and Allotment Book.

(6) Check all such receipts from the Cash Book into the Bank Pass Book.

(7) Check the postings of the entries from the Application and Allotment Book into the Share Ledger or the Register of Members.

(8) Vouch the moneys refunded, if any, for shares not allotted with the acknowledgments from the Applicants, and see that proper entries in this respect are made in the Cash Book as also in the Application and Allotment Book.

(9) In regard to further Calls made, see the Board's Minutes and check the counterfoils of the receipts into the Cash Book. Check also the same

amounts into the Call Books and from thence into the Share Ledger or Register of Members.

(10) Check all the receipts in respect of Calls from the Cash Book into the Bank Pass Book.

(11) Vouch Journal Entries in regard to the issue of shares with the Board's resolutions, and, if any Premium is called, see that the same is credited to a separate Share Premium Account.

(12) Check the postings from the Cash Book and the Journal to the Share Application, Share Allotment, Share Call and Share Capital Accounts.

(13) Get a complete list prepared from the Share Ledger or the Register of Members, of the number of shares issued, the amounts called, the amounts received on account thereof and the amount of calls in arrears, if any, and see that these totals tally with the Share Capital Account and the balances on the Call Accounts in the Financial Ledger.

(14) In regard to the issue of fully-paid shares to the Vendors, check the Company's contract with the Vendors and see that the fact is disclosed in the Prospectus. See also the Board's Minute as to the allotment and ascertain that a written contract in respect of such allotment is filed with the Registrar.

An exhaustive audit in regard to the Share Capital as indicated above need only be done once after the issue of shares in a newly-formed company, and the auditor will not then be responsible in respect of the Share Transfer Work.

Q. 53. *The Directors of a Company desire to utilise the Premium received on the issue of Shares for distribution as dividend by transferring the credit to Profit and Loss Account. Would you as an auditor object to such a procedure?*

A. It is not desirable financially to utilise the amount received by way of Premium on Issue of Shares in distribution as dividend to shareholders. The usual practice is to utilise this amount, which is in the nature of a capital profit, in writing off some fictitious assets such as Preliminary Expenses, Underwriting Commission, etc., or in writing down some Fixed or Floating Assets, which might be overstated in the books. There is nothing, however, to prevent this premium from being utilised as part of divisible profits unless the Articles of the Company provide otherwise.

If, however, it is desired to distribute this premium, it is preferable to do so by way of a special dividend or a bonus dividend and credit the amount to Profit and Loss Appropriation Account rather than treating the same as part of the trading profits of the business.

The auditor should see that the Company's Articles do not prohibit distribution of such a capital gain.

Q. 54. *Is a Company legally bound to replace lost capital out of revenue before declaring a dividend? State fully the reasons for your answer.*

A. If the Articles of the Company specifically provide that its capital must be kept intact before arriving at the divisible profits, then the company is under a legal obligation to provide for the lost capital before declaring a dividend; but if the Articles do not specifically mention the point, then the declaration of a dividend out of profits without providing for lost capital is not an illegal course, provided the revenue account is prepared on some correct basis and discloses divisible profits. It must be noted, however, that a distinction must be drawn between Fixed and Floating Assets before arriving at the amount of the profit available for dividend, for fixed capital may be sometimes lost and yet the excess of current income over current expenditure may be divided, but floating or circulating capital must be kept up. In other words, in the absence of anything to the contrary in the company's own Articles, there is no obligation on a company to provide for the loss of fixed assets in every case and under every circumstance, but loss on floating or circulating assets must be made good before arriving at the profits available for distribution.

Q. 55. *If, owing to bad trade, the Directors decide not to draw their Fees, what course would you adopt?*

A. If the auditor is informed by the directors of a company that owing to bad trade they have decided not to draw their fees, it will be his duty to see that a resolution to this effect is recorded in the Minute Book and signed by all the directors, whereby they agree to waive their right to their fees for the period covered by the audit. In case of a director being absent, an agreement under seal would be necessary to release the company from the liability to pay him such fees. If this is not done, the auditor must insist upon the inclusion of such fees in the account.

Q. 56. *Are Capital Profits arising from the sale of fixed assets available for distribution as Dividend?*

A. Such capital profits are not available for distribution as dividend unless the following conditions are fulfilled:—

(1) That the Company's Articles of Association do not prohibit such a distribution;

(2) That the surplus is in a realised form; and

(3) Such surplus remains after a proper re-valuation of all the other assets of the company.

Q. 57. *If a Trust Company has earned sufficient profits to enable it to pay the usual dividend in a particular year, when the*

market value of its Investments stands considerably fallen, how should you deal with such a situation while auditing the accounts ?

A. In a Trust Company, the Investments are classed as its Fixed Assets and, under the circumstance, there is no legal binding on such a concern to bring down the book value of its investments to market price, if the latter happens to be lower, unless its Articles provide otherwise. As long as the company is in a position to pay its debts as and when they arise, and as long as its Profit and Loss Account is constructed on the right lines, there is no necessity for the company to bring into account the fall in the value of its investments.

From the view-point of sound finance, however, if the fall is of a permanent nature, it is highly desirable that a reserve should be made in respect thereof before declaring a dividend. In any case, it would be desirable to indicate the Market Price of the Investments on the face of the accounts underneath the item itself, in case the same is below their cost price.

Q. 58. *An Engineering Company has built a new workshop in place of the old one and equipped it with some new plant. Part of the work was executed under contracts and part by the company's own men. In order to provide increased steam power, an engine of larger capacity had to be purchased in place of the old one which was sold. How would you satisfy yourself as to the correctness of the amounts charged to Building Account and Plant Account ?*

A. Building Account.—The amounts paid or credited to the Contractors will be verified with the contracts with Builders, Architects' Certificates and Builders' Receipts. In regard to the work done by the company's own men, the Building Account would already be debited with the cost of the material and labour consumed thereon as also with any chargeable expenses, and it would be necessary to obtain a certificate in this respect from the Company's Chief Engineer to the effect that these amounts have been properly arrived at and do not include any item rightly chargeable to revenue. The cost of pulling down the old works will be a charge against revenue, and after the Old Works Account is credited with the amount realised on the sale of old materials and the cost of materials utilised in the new works, the balance of book value if any left on this account will be written off to revenue. If, however, the amount chargeable to revenue is abnormally heavy, the same may be written off over a period of three to five years.

Plant Account.—The amount realised on the sale of the old engine will be credited to Plant and Machinery Account, and any difference between its book value and the sale price must be written off to revenue. The cost of the new engine and other plant as also the cost of erection will be debited to New Plant and Machinery Account, after being duly vouched with the Invoices and Receipts from the suppliers.

Q. 59. *A Company has issued 7½% Debentures of Rs. 10,00,000, at a Discount of 5% repayable at par at the end of 20 years. As an auditor, how would you advise such a discount to be dealt with in accounts and what would be the company's position in regard to the creation of a Debenture Redemption Fund?*

A. When Debentures are issued at a discount and are repayable at par, the loss thus suffered should be debited to a special account styled "Discount on Issue of Debentures Account". Where they are redeemable at the end of a specified period, as in the above case, the loss on discount should be spread equally over the number of years for which the Debentures are to run, but in case they are irredeemable, the discount should be written off over a reasonable period. The balance of discount so far not written off will appear in the Balance Sheet on the assets side under its distinct heading "Discount on Debentures," whereas the Debentures will appear at their face value from year to year as a liability until they are paid off.

There is no legal obligation on a company to provide for the redemption of its Debentures by means of a Debenture Redemption Fund, unless it is so required by its Articles or by the provisions of the Trust Deed on behalf of the Debenture-holders. Where such a provision is required to be made out of profits, the auditor should see that the requirements under the Articles or the Trust Deed are duly fulfilled from year to year, and that the amounts set aside are invested in gilt-edged securities, and allowed to accumulate at compound interest. Such a provision, if any, will appear on the liabilities side of the Balance Sheet under the heading of "Debenture Redemption Fund," and its corresponding investment, on the assets side under the distinct head "Debenture Redemption Fund Investments."

Where no such provision is required by the Articles or the Debenture Trust Deed, the auditor can only advise the creation of such a Fund, but he cannot insist on the same being maintained.

Q. 60. *To what extent is an auditor liable, if it is subsequently ascertained that the accounts of the company he had certified were false or fraudulent?*

A. An auditor is supposed to use the utmost care, skill and judgment in the due performance of his duties, and if, as a result of his examination, he has traced any irregularities, it is his duty to lay before the shareholders all the material facts relating to accounts and conceal nothing from them. His duty does not end by drawing the attention of the directors only to such matters as call for a special report to the shareholders. Besides, he should state whatever he means to convey to the shareholders in a clear and unmistakable language, and must give them information and not the means of information in regard to the company's financial position, otherwise he runs the serious risk of being held to have failed to discharge his duty.

An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. But he must be honest, i.e., he must not certify what he does not believe to be true, and he must exercise reasonable care and skill before he believes that what he certifies is true. He must not be made liable for not tracing out ingenious and carefully laid schemes of fraud, when there is nothing to arouse his suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors.

An auditor is an 'officer' of the company under Sec. 235 of the Indian Companies Act, 1913, and, as such, he is liable in the event of winding up to make good to the company any loss or damage occasioned by misfeasance or breach of trust on his part.

He is also liable to fine, imprisonment or both under Sec. 282 of the Act for wilfully making in any Report, Balance Sheet or other document, a statement false in any material particular, knowing it to be false.

Q. 61. *Is there any difference between the position of an auditor to a Partnership and an auditor appointed under the Companies Act, so far as the legal duties and liabilities of auditors are concerned?*

A. In case of a partnership firm, the auditor is not appointed under statute, as there is no legal obligation on such firms to have their books audited. The auditor, in this case, is appointed by mutual agreement between the partners, and he will have to be guided in his duties by the Partnership Deed or in the absence of such a Deed, by a letter from the partners setting out the terms and conditions on which they have agreed to work. In a Limited Company, the audit is obligatory under the Companies Act, and the rights and duties of the auditor are defined by Statute. The auditor is appointed by the shareholders, or, by the Directors on their behalf in certain instances, but his statutory duties cannot be limited or altered in any manner, although the same can be extended under terms of appointment. In a partnership firm, the rights and duties of the auditor would be defined by the agreement between the partners, and these can be limited in any direction. If, however, an auditor is called upon to conduct a partial audit, he should take care to see that he makes his position clear in the certificate at the foot of the Balance Sheet. It is important, therefore, for an auditor to see that on his appointment as such in a partnership firm, the precise nature of the work he is called upon to perform is clearly set out in writing signed by all the partners, so that in case of any subsequent dispute as to the extent of his responsibility, such a letter as abovesaid may help the auditor considerably in proving his case.

So far his liability for neglect or default is concerned, his legal position is the same both as an auditor to a partnership or to a limited company. The same may be said in regard to his liability to third parties. In either case, if as a result of any negligence or default on the part of the auditor in

the due performance of his duties, any loss or damage is suffered by the client, the auditor would be held responsible for such damage. He would not be liable, under such a circumstance, to a third party as he owed no duty to him. Where, however, an auditor wilfully signs a false statement of accounts, he is equally liable to third parties who relied on such statement and suffered loss.

Q. 62. *In auditing the accounts of a Charitable Institute, what information and evidence would you require before certifying the annual accounts?*

A. The receipts on account of subscriptions and donations will have to be checked with the counterfoils of the receipts issued. The auditor must naturally inquire into the system of internal check as to the collection of subscriptions. It should be seen that all receipts are entered in the cash book in consecutive order and that no number is missing. The auditor should see that spoilt or cancelled receipts are not destroyed but are initialled as such and produced to him.

If the periodical lists of subscriptions and donations are published in any newspapers, he should ask for their cuttings and check the same with the counterfoil receipts and also see that the total amount received as acknowledged therein agrees with the total amount as shown by the books of account. Where a receipt is not issued to the payer, he should ask for some documentary or other evidence to ascertain the correctness of the amount recorded, and if any information or explanation is lacking, the auditor should report on the point concerned.

The investments should be carefully verified and it should be seen that periodical interest or dividend is brought into record.

In regard to payments, these should be evidenced by proper vouchers in shape of acknowledgments from the payees. He should further see in this connection that every payment is duly sanctioned by some one in authority, and all unusual payments are properly explained.

Q. 63. *What particulars are required by the Indian Companies Act, 1913, to be entered in the Register of Members?*

A. Section 31 of the Indian Companies Act lays down as follows in connection with the Register of Members which must be maintained by every company.

Every company shall keep in one or more books a register of its members and enter therein the following particulars:—

- (i) the names and addresses, and the occupations, if any, of the members and, in the case of a company having a share capital, a statement of the shares held by each member, distinguishing each share by its number, and of the amount paid or agreed to be considered as paid on the shares of each member;

- (ii) the date at which each person was entered in the register as a member; and
- (iii) the date at which any person ceased to be a member.

(2) If a company makes default in complying with the requirements of this section, it shall be liable to a fine not exceeding fifty rupees for every day during which the default continues; and every officer of the company who knowingly or wilfully authorises or permits the default shall be liable to the like penalty.

Q. 64. *A large Reserve Fund having been accumulated out of profits, the Directors seek your advice as to the distribution of a part thereof in shape of Bonus Shares. What are the advantages and disadvantages of such a procedure ?*

A. The advantage as also the disadvantages arising from a distribution of a part of the Reserve Fund in shape of Bonus Shares may be summarised as under:—

The advantages are—

(1) As a result of the permanent retention of a part of the distributable profits, the financial strength of the company would be improved due to increase in its working capital.

(2) If the Reserve Fund is utilised in the business, the capital on which the dividends are declared will represent the effective capital employed in earning the income.

(3) The shareholders can readily realise their Bonus Shares if they wish to do so, and this would in no way affect their original holding.

The disadvantages are—

(1) Owing to a permanent increase in the capital, the future rate of dividend may very likely fall, unless the company is in a position to advantageously employ the capitalised profits.

(2) The company may not be able to find profitable employment for the additional capital during periods of trade depression.

(3) The reserved profits being once capitalised may not be available for equalising dividends or for meeting unforeseen contingencies if any arise in the future.

Q. 65. *What do you understand by the following, and what are the duties of an auditor in respect of each of these :—*

- (a) *Specific Reserve ;*
- (b) *Reserve Fund ;*
- (c) *Sinking Fund ; and*
- (d) *Depreciation Fund ?*

A. Specific Reserve.—This is a provision made against estimated losses by way of Bad Debts, Discounts, etc. Such reserves must be provided for even though no profits are shown by the accounts, and the corresponding charge must be on Profit and Loss Account. The auditor's duty in this connection would be to see that all losses actually sustained as also those estimated must be set off against the income of any one period before the ascertainment of the true profit or loss of that period.

Reserve Fund.—This fund is created by setting aside a portion of divisible profits for the purpose of either strengthening the financial resources of the business, or for equalisation of dividends, or for contemplated expansion of business, or for enabling it to meet unforeseen losses that may arise in the future. Unless the Articles specifically provide for a certain portion of the profits to be transferred to Reserve Fund prior to distribution of dividends, the question as to whether or not any amount of profits is to be set aside is usually left to the discretion of the directors, whose proposal in this direction is generally sanctioned by the shareholders in general meeting. The auditor must refer to the Company's Articles to ascertain if there are any specific provisions in regard to Reserve Fund, for; if so, he must see that they are rigidly adhered to. In the absence of any such provisions, he should refer to the Minute of Resolution passed at the General Meeting in regard to transfer of an amount to such a fund. The sum representing the Reserve Fund may or may not be invested in gilt-edged securities outside the business as the directors may deem fit, subject to the Company's Articles.

Sinking Fund.—This is a fund created and maintained out of divisible profits with a view to provide for the repayment of a known liability at the end of a definite period. A good example of Sinking Fund is provided by the Debenture Redemption Fund. In this case, such an amount is set aside out of profits each year as would accumulate with compound interest at the end of a specified period to a sum necessary for the redemption of the liability. The sum set aside each year should be invested in gilt-edged securities so that the same may be realised when the loan becomes repayable. There is no legal obligation on a company to provide for the repayment of loans or debentures by means of such a fund, unless the company is so required to do by its Articles or by specific provision in the Trust Deed on behalf of Debenture-holders. When such a fund is created, the auditor should see that the provisions under the Articles or the Trust Deed are duly carried out.

Depreciation Fund.—Occasionally, instead of crediting the depreciation provided for to the asset account in question each year, the amount is credited to a separate account styled Depreciation Fund Account; and, with a view to enable the company to replace the asset at the end of its usefulness to the business, a corresponding sum is invested in gilt-edged securities and allowed to accumulate at compound interest. The auditor should ascertain that the amount of depreciation set aside each year is reasonably adequate and should

inspect the Board's or the Shareholders' Resolution, or the Company's Articles in this behalf. He should see that the corresponding Investments are earmarked and distinctly shown on the Balance Sheet.

Q. 66. *A Limited Company registered on 30th June 1938 takes over a running business as from 31st March 1938. How would you ascertain and deal with the profits earned prior to incorporation ?*

A. Where, according to its agreement with the vendors a company is entitled to profits earned prior to the date of its incorporation, such profits cannot be regarded as available for dividend but as capital profits, for the simple reason that a company cannot earn profits before it comes into legal existence. The first charge on such profits will be the amount of interest on purchase price upto the date of incorporation, payable to the vendors. The balance of the profit earned prior to incorporation may be utilized in writing off Goodwill, or, if there be no Goodwill, in writing down some other Fixed Assets, or may be carried forward as Capital Reserve not available for dividend.

In the absence of stock being taken at the date of incorporation, the apportionment of profits between the period prior to incorporation and that subsequent to the incorporation may be made according to the time or the turnover, the latter being the more correct method. Sometimes, both these methods are resorted to, the gross profit being apportioned according to the turnover of the two periods, the expenses representing standing charges according to the respective periods, and those having any bearing on the turnover, such as commission to travellers, travellers' expenses, advertisements, etc., on the basis of turnover.

Q. 67. *A private firm is to be converted into a public limited company. To enable a public issue of shares, you are required to give a certificate as to the average past profits of the firm for inclusion in the prospectus. What adjustments would you have to make in the profits as shown by the firm's books, and how would you qualify the certificate by reason of the adjustments ?*

A. The following are the usual adjustments which will have to be made and these would add to the profits as shown by the Accounts already prepared:—

- (a) Interest on Partners' Capital and Current Accounts, Partners' Salaries and Income-tax.
- (b) Interest on Loans and Overdraft, if any, except where any existing loan is to be taken over by the company, otherwise it would be assumed that the company will have sufficient working capital without any borrowing, in which case Interest charges will not be incurred.

- (c) Rent, if the company is going to purchase the Trade Premises which were till then rented by the Business.
- (d) Discount on Purchases, where owing to insufficient working capital, the business could not avail itself of this source of income, and it is expected that the company will have sufficient capital to enable it to benefit from discount.
- (e) Exceptional losses, e.g., costs and damages incurred by actions at law, defalcations and other losses not arising out of the ordinary course of business and of a non-recurring nature.
- (f) Capital losses, e.g., loss on sale of Investments or any other Fixed Assets; loss by fire where the assets were under-insured, although in such cases, the full Insurance Premium should be charged.
- (g) Any Capital Expenditure charged to Revenue.
- (h) Any excessive reserve for Bad Debts or other contingencies.

The following adjustments will have to be set off against the profits:—

- (a) Income from assets which are not taken over by the company.
- (b) Rent of the premises belonging to the business, where premises are not taken over by the company, and no charge had been made in the Profit and Loss Account in respect of this item.
- (c) Exceptional profits, e.g., speculation profits, insurance profits, compensation received for compulsory removal of premises.
- (d) Capital profits, such as those arising on a sale of Investments or Fixed Assets.

The item of depreciation will require to be dealt with carefully. If it is practicable, a charge in respect of this must be made against the profits. Where not practicable, owing to ignorance of values at which the company is prepared to take over the various assets, it is advisable not to charge any depreciation against profits rather than put a figure which may be quite misleading. In the latter case, the amount of depreciation charged in the past should be added to the profits, and the Certificate should make a specific mention of the omission of such charge in the Profit and Loss Account.

The certificate should refer to the exact period of investigation and must be drawn up in a clear unambiguous language. It should mention that all necessary adjustments have been made by the Accountant, and should refer specifically to important adjustments.

The certificate should set out the profits of each year separately, and not the average profits only. It should not claim to give any estimates, or opinion, or enter into assumptions, but should restrict itself to questions of facts only.

Q. 68. *On auditing the accounts of a company, you find that several shareholders have paid calls in advance. No provision for*

interest on these calls is made, and on enquiry, you are told that no such interest is payable as the company's working of the year has resulted in a loss. Can you accept this contention?

A. The contention cannot hold good inasmuch as the Company's Articles may require Interest to be paid on Calls in advance, in which case such interest is payable whether the company makes a profit or loss. If the company's own Articles are silent on the point and Table A is not expressly excluded, Clause 17 of Table A which authorises the payment of interest at the rate not exceeding 6% as may be agreed upon between the Members and the Company, will apply.

Under such a circumstance, the liability in respect of Interest on Calls in advance must be brought into account, while preparing the Final Accounts of the Company.

Q. 69. *Is it permissible for a company after having written down in the past some of its assets excessively out of profits, to write them up again on a subsequent occasion and credit the excess to Profit and Loss Account for the purpose of Dividend?*

A. As decided in the case of *Stapley vs. Read Brothers, Ltd.*, a company having written down its assets excessively out of profits may on a future occasion write them up again to the extent of such excess, and by crediting the amount thus rendered available to the Profit and Loss Account may utilise the same for distribution as dividend. The only necessary condition is that the assets in question are not shown in excess of their present true value to the business concerned.

Q. 70. *What steps should a company take where an auditor other than the retiring auditor is to be appointed?*

A. Where an auditor other than the retiring auditor is to be appointed, the following procedure must be followed:—

(a) The notice of the intention to nominate that person to the office of auditor should be given by a member of the company not less than 14 days before the annual general meeting; and

(b) The company should send a copy of such notice to the retiring auditor and also to the members not less than 7 days before the annual general meeting.

Q. 71. *Where a company has issued Redeemable Preference Shares, what would be your duty as an auditor in this connection?*

A. Where Redeemable Preference Shares are issued, it would be the duty of the auditor to see that the Company's Articles authorise such an issue, otherwise the Articles will have to be altered to enable the Company to issue such shares. It should further be seen that the share capital item in the

Balance Sheet clearly indicates what part of the Issued Capital consists of such shares, and the date on or before which they are liable to be redeemed.

Q. 72. *As an auditor, what steps would you take to verify the redemption of Redeemable Preference Shares?*

A. When Redeemable Preference Shares are redeemed, the auditor should examine the Board's Resolution in regard to such redemption, and should ascertain that the provisions of Section 105-B have been duly complied with, and the necessary transfer have been made to the Capital Redemption Reserve Fund. He should further vouch the payments with the returned share certificates, and see that the necessary entries as to the redemption are made in the Register of Members. Where new shares are issued to enable such redemption to be made, he should verify the entries relating thereto in the financial records as also in the Register of Members.

Q. 73. *State briefly your duties as an auditor in regard to the following :—*

- (a) *Directors' and Managing Directors' Expenses ;*
- (b) *Loans to Directors ; and*
- (c) *Remuneration of Managing Agents.*

A. (a) Directors and the Managing Director are entitled to be paid any expenses properly incurred by them on the Company's business, but in the absence of any specific provision in the Articles, they are not entitled to claim from the Company travelling expenses incurred by them in attending Board Meetings. Where the Articles entitle them to receive travelling expenses incurred in attending Board Meetings or otherwise on the Company's business, the auditor should examine the particular clause and see that the amount charged is not excessive.

(b) Loans to Directors are now strictly forbidden under Section 86-D. This prohibition relates also to partnerships in which a director is a partner, and to private companies in which such director is a director. The only exception is in case of Banking Companies where there is no legal objection to any of its directors borrowing as ordinary customers. If the auditor finds any loan having been granted to a director, he must report the fact specially to the shareholders.

(c) For the purpose of passing the Managing Agents' remuneration, the auditor should satisfy himself that the amount payable is ascertained in strict accordance with the Managing Agents' Agreement or as sanctioned by the resolution of the shareholders. Where the remuneration of the Managing Agents is in any form other than that as prescribed under Section 87-C, it should be seen that the same is sanctioned by a special resolution of the shareholders.

Q. 74. *As an auditor to a Limited Company, you are not satisfied with the form in which the Directors propose to present accounts to the shareholders. How would you proceed?*

A. An auditor cannot insist upon any particular form of accounts to be presented to the shareholders, nor is it his duty to draft such accounts. As a matter of fact, the form of Balance Sheet is prescribed by the Indian Companies Act and the auditor is to see that all the various assets and liabilities are properly grouped and shown under their appropriate heads and that such Balance Sheet embodies within itself the whole of the information as is required by the Act.

The auditor should further see that the form as proposed by the Directors is on a line with the one as is contemplated by the Act and the statements submitted to him exhibit a true and correct view of the state of the Company's affairs and serve to provide the shareholders with the whole information they are entitled to receive under the Act.

Where the auditor is not satisfied with the form in which the accounts are proposed to be submitted to the shareholders, he should use his utmost endeavours to persuade the directors to make the necessary amendments, and if they refuse to do so, his only remedy is to state the facts clearly in his report to the shareholders.

Q. 75. *Discuss the desirability or otherwise of an auditor allowing Secret Reserve to be maintained without disclosing the fact to the shareholders.*

A. There is no hard and fast rule prescribed as to what attitude an auditor should take up towards the maintenance of a Secret Reserve by any company, as this would depend on the nature of the Company's business and the circumstances under which any such reserve is maintained. If he finds that such a reserve is necessarily required with due regard to the nature of the Company's business, that it is kept within reasonable limits and that it is so maintained in the best interests of the Company, he need not object to its creation and maintenance, nor would it seem to be his duty to report the fact to the shareholders. If, however, there is any doubt in his mind as to the reasonableness or otherwise of the secret reserve, or where he finds that such a reserve is utilised by those in management to substantially augment the Company's profits from year to year so as to present a false impression as to the true working results, it would become his duty to incorporate in his report such further information as he may deem necessary in order to bring the fact to the notice of the shareholders. In any case, the auditor must exercise his discretion in the matter before he decides upon disclosing the existence of a Secret Reserve Fund to the shareholders. He should see that he does not do anything whereby the interests of the shareholders are prejudiced in any way.

Q. 76. *How should assets be stated in a Company Balance Sheet, under the Indian Companies Act, 1913-1936?*

A. The requirements as to the disclosure of assets in a Company Balance Sheet, under the Indian Companies Act, 1913-36, may be summed up as under:—

(1) The Fixed Capital Expenditure must be shown first, and the expenditure on the several assets acquired, such as Land, Buildings, Plant, Machinery, Trade Fixtures, Tools, etc., must be separately shown. Goodwill, if any, acquired should also be included amongst the fixed assets.

(2) Each such asset should appear at its original cost and the Depreciation, if any, provided for should be shown by way of deduction from the relative asset. The Depreciation provided upto the beginning of the year and the amount set aside during the year should be separately shown.

(3) Any additions to Fixed Assets made during the year under review, as also any deductions therefrom by way of sale of any discarded asset should also be distinctly stated.

(4) If any Interest has been paid out of Capital during construction, the same may be capitalised, but must be clearly specified on the assets side.

(5) Preliminary Expenses, Brokerage on Shares, Underwriting Commission and Discount on Issue of Debentures are allowed to be shown on the assets side until written off, but they must appear under their distinct heads. The Balance Sheet of each year should show the amount originally expended, and the amount written off so far would appear as a deduction.

(6) The Stock-in-trade item must clearly disclose the mode of valuation.

(7) The Book Debts should be distinguished between good and doubtful. All known bad debts would be presumed to have been written off. The Provision, if any, made in respect of Doubtful Debts will appear on the liabilities side.

(8) Debts owing by Directors or other officers of the Company must be specifically disclosed.

(9) Pre-paid Expenses must appear separately from Loans, if any, granted. Loans to Subsidiary Companies must be shown separately from other loans and advances.

(10) The Investments should be classified into—

(a) Government or Trust Securities;

(b) Shares or Debentures of Public Companies clearly indicating whether they are fully or partly paid up; and

(c) Shares or Debentures of Subsidiary Companies.

(11) The mode of valuation of Investments must be clearly specified.

(12) Interest accrued on Investments to date of Balance Sheet should be separately shown.

(13) The Cash and Bank Balances should appear under their distinct heads..

(14) If any asset has been written down on a reduction of Capital or as a result of a re-valuation, each subsequent Balance Sheet should disclose the date and the amount of such reduction.

(15) If any "Organization or Development Expense" has been temporarily capitalised, the same must appear under its descriptive head.

Q. 77. *Where shares have been issued for consideration other than cash, what would be your duty as an auditor ?*

A. Usually, fully or partly-paid Shares are issued to the Vendors, in which case, the following steps will have to be taken by the Auditor to verify these:—

- (1) See the Contract with the Vendors;
- (2) Examine the Board's Minute recording the allotment;
- (3) See that the Prospectus discloses such a contract;
- (4) If these are issued to the promoters under contract, verify the terms of issue with the Contract and examine the Board's Minute regarding such allotment;
- (5) Where these are issued to the Underwriters, the contract with the Underwriters, as also the statement in the Prospectus and the Directors' Minute should be seen;
- (6) See that such issue is properly recorded by means of a Journal entry;
- (7) The issue of such fully or partly-paid shares will have to be shown separately from the shares issued for cash, on the Balance Sheet; and
- (8) It should be seen that the contract in question is filed with the Registrar of Companies.

Q. 78. *The Directors of the Patent Products Ltd., having expended enormous sums in production of and in advertising newly patented articles, seek your advice as to how such sums should be dealt with in the final accounts. What would you advise ?*

A. Any expenditure which the company has incurred in experimental work and in acquisition of Patents may be debited to an account styled Development Account. Although it would not be desirable and proper to charge off such expenses in their entirety to revenue in the year in which they have arisen, it would seem necessary to write them off over the number of years for which the products are likely to command sales. Similar treatment should be accorded to any abnormally heavy amounts spent in advertising in the initial stages of marketing of the new products. In any case, it would be objectionable to permanently capitalise such amounts.

Q. 79. Describe your duties as an auditor of a Holding Company.

A. The auditor of a Holding Company will have to look into the following additional points over and above those which relate to any other audit:—

(1) That the Holding Company's Balance Sheet is accompanied by the Balance Sheets of its Subsidiaries;

(2) That the Balance Sheet of the Holding Company shows any indebtedness to or from the Subsidiaries separately from other items;

(3) That it also discloses the shareholdings in the Subsidiary Companies and that such shares are valued on a proper basis;

(4) That there is annexed to its Balance Sheet a statement showing how the aggregate profits or losses of the Subsidiaries have been dealt with for the purposes of the accounts of the Holding Company, and to what extent provision has been made for losses of a subsidiary in the accounts of that company or of the Holding Company;

(5) It should be seen that the profits or losses to be dealt with in the said statement should be for the period ended within the period of the Holding Company's accounts, or, if no such accounts are available, the previous accounts which became available in such period;

(6) If the auditor of any subsidiary company has qualified his Report attached to the Balance Sheet of the Subsidiary, particulars of such qualifications must be mentioned in the above-said Statement;

(7) The auditor should carefully verify the inter-company transactions; and

(8) He should finally see that the whole of the assets and liabilities are properly grouped and classified and that the Balance Sheet clearly and correctly discloses the true state of the company's financial position.

Q. 80. If called upon by the Directors of a Holding Company to prepare its Consolidated Balance Sheet, describe the points on which you would direct special attention.

For answer see pages 219-221.

Q. 81. What would be your duties in regard to increase in Share Capital?

A. A company can increase its share capital, if so authorised by its Articles. The increase should be effected by the Company in general meeting, and an ordinary resolution will suffice unless the Articles provide otherwise. The auditor's duty would be to consult the Articles and inspect the resolution authorising the increase. He should further ascertain that the notice of the increase of capital has been duly filed with the Registrar.

Q. 82. *A Company having reorganised its Share Capital, describe the steps you would take to verify the transactions.*

A. Where any reorganization of Share Capital takes place, under Section 54 of the Indian Companies Act, the Auditor should take the following steps to verify the transactions resulting therefrom:—

(1) He must verify the 'Shareholders' Minutes recording the Special Resolution;

(2) He should examine the Court's Order sanctioning such reorganization;

(3) He should ascertain that the copy of the Court's Order has been duly filed with the Registrar;

(4) The Journal entries arising from such reorganization will have to be carefully vouched;

(5) The cancelled share certificates will have to be checked with the counterfoils of the new share certificates issued; and

(6) The Share Register should be examined to see that the necessary adjustments have been made therein.

Q. 83. *What would be your duties as an auditor, upon the Reduction of its Share Capital by a Limited Company?*

A. The duties of an Auditor upon the Reduction of Share Capital of a company will be as under:—

(1) He should consult the Company's Articles to ascertain if such a Reduction is authorised, and if there is no such authority, he should see that the necessary Article is inserted by means of a Special Resolution;

(2) He should verify the Special Resolution giving effect to such Reduction from the Shareholders' Minute Book;

(3) He should inspect the Court's Order confirming the Reduction, and see that the Court's Order as also the Minute in respect of the Reduction have been filed with the Registrar, and the latter's Certificate has been obtained;

(4) He should examine the Register of Members to ascertain that the necessary alterations have been effected;

(5) He should check the cancelled Share Certificates with the counterfoils of the new ones issued, or ascertain that the fact of the Reduction of Share Capital has been endorsed on the Old Share Certificates;

(6) He should examine the Journal entries necessitated by such Reduction; and

(7) He should see that the fact of such Reduction is clearly indicated on the Balance Sheet with the words "And Reduced", for such a period as is required under the Court's Order.

Q. 84. *Under what circumstances would you pass issue of Shares at a discount ?*

A. The auditor should see that the issue of shares at a discount is authorised by a resolution passed in General Meeting and is sanctioned by the Court. He should see that at least one year has elapsed since the Company was entitled to commence business, and such shares are issued within six months of the sanction of the Court. Every Balance Sheet issued by the Company subsequent to the issue of the shares must contain particulars of the discount allowed and of so much of that discount as has not been written off to the date of the Balance Sheet.

Q. 85. *How would you verify payment of Underwriting Commission ?*

A. The auditor should see that such payment and the rate per cent payable are authorised by the Articles and are disclosed in the Prospectus. The agreement with the underwriters must be inspected, and it should be seen that the necessary application deposit and allotment and call moneys in respect of the shares the underwriters are called upon to take over have been duly received from them. The payment of Commission must be verified with their receipts, and the Board's Minute regarding the allotment to the underwriters must be inspected. Where fully or partly paid shares have been issued to the underwriters in satisfaction of their Commission, the auditor must verify the same with the Board's Minute, and must ascertain that the contract in this behalf has been filed with the Registrar. The auditor should see that the amount paid for Underwriting Commission is specifically disclosed in the Balance Sheet until written off.

Q. 86. *State what restrictions have been placed on Directors contracting with their own company, by the Indian Companies Act, 1913-1936.*

A. No Director of a company, or the firm of which he is a partner, or any partner of such firm, or a private company of which he is a member or a director, can enter into any contract with his company for the purchase or sale of goods and materials except with the consent of the directors.

If a director is interested in a contract or a proposed contract with the company, he should declare his interest at the meeting of the Board at which such contract is determined on. In case the contract is already made, he should declare his interest at the earliest meeting of the directors after the making of such contract.

The Director who is interested in a contract is prohibited from voting at the Board Meeting at which his contract is considered, and his presence will not be counted for the purpose of forming a quorum for such voting.

Q. 87. *Can the Managing Agents invest the company's surplus funds or borrow moneys on debentures?*

A. The Indian Companies (Amending) Act forbids managing agents from issuing debentures and restricts their powers to invest the funds of the company, except with the authority of the directors and within the limits fixed by them.

Q. 88. *While auditing the first year's accounts of a public company, on what particular points would you consult the Prospectus and the Articles?*

A. While auditing the first year's accounts of a company, the auditor will have to consult the Prospectus and the Articles in regard to the following matters:—

(a) The share capital and its division into the different classes of shares;

(b) Minimum Subscription, Underwriting Commission and Brokerage on shares;

(c) The Borrowing Powers of the company;

(d) Qualification Shares of the directors;

(e) Property acquired from the vendors, and the consideration payable to them;

(f) Remuneration of the directors, the managing director and the managing agents;

(g) To see that the Preliminary Expenses actually incurred do not exceed the amount stated in the Prospectus; and

(h) Forfeiture of Shares.

Q. 89. *Would you consider the lodgment by the borrower of fully-paid share certificates in another company with unstamped Transfer Forms executed by him, but with the name of the transferee, consideration and date of transfer left blank, a sufficient security for a loan advanced by a company?*

A. The auditor cannot pass such an advance as a secured loan, as the deposit of share certificates in the borrower's name together with a blank transfer executed by him, will not constitute a legal security. It would still be open to the borrower who is evidently the registered holder of the shares to transfer such shares without the knowledge of the company with whom they have been lodged as security, as many companies take power under their Articles to issue duplicate shares on receipt of a letter of indemnity from the registered holder. As the transfer is left incomplete for want of date and the transferee's signature, it is no protection for the lender, nor does it give him a legal title to the shares concerned.

Q. 90. *A company desirous of extending its factory premises asked for tenders and the lowest quotation received was for Rs. 75,000. The management then decided to have the work executed by their own workmen, and the cost in labour, material and direct charges worked out at Rs. 55,000. The directors wish to debit the capital cost of extension with a further sum of Rs. 20,000 to bring it in line with the lowest estimate and credit the difference to Profit and Loss Account, on the argument that if they had the work done under contract, it would have cost the company Rs. 75,000. What views would you express as an auditor ?*

A. The directors can under no circumstance increase the value of the extensions beyond what it has actually cost the company. It would be wrong in principle to take credit for an unrealised profit and utilise the same for dividend purposes, for it would amount to paying dividend out of capital. The item in question is a fixed asset, and there can be no justification in writing up its value and giving a corresponding credit to Profit and Loss Account simply because the company was able to carry out the extension at less than the lowest tender. There can, however, be no objection to the directors adding a reasonable percentage in respect of administration expenses to the direct cost of the extensions.

Q. 91. *A Tramway Company having decided to convert its working into electric traction had to spend Rs. 27,00,000 towards re-equipping the line as well as the rolling stock, plant, etc. Besides, the whole of the existing equipment which stood in the books at Rs. 7,50,000 had to be discarded and sold at Rs. 2,50,000. In the first year's working after the conversion, the company made a net profit of Rs. 3,50,000. State your views, if the directors propose to utilise this sum in payment of dividends.*

A. The cost of Rs. 27,00,000 arising from re-equipment due to the change in the system of traction is necessarily capital expenditure. The loss of Rs. 5,00,000 resulting from the sale of old equipment can also be considered as additional cost of the altered system of traction, and there can be no legal objection to it. Financially, however, it would be more prudent to only temporarily capitalise this loss and write it off over a period of five to ten years.

• Legally, therefore, the company can distribute as dividends the whole of the profit made without providing for any portion of the above loss.

Q. 92. (a) *The Managing agents have entered into contracts for the sale of raw materials to their company ;*

(b) *They have advanced money to the company ; and*

(c) *There has been an increase in their remuneration. How would you as an auditor pass these transactions ?*

A. (a) The auditor will have to verify the resolution passed by an independent quorum of at least three-fourths of the directors at the meeting at which the contract with the managing agents was dealt with.

(b) Where the managing agents have advanced loan to the company, the auditor should see that the closing balance of such loan account is disclosed as a separate item in the Balance Sheet. He should determine if such loan was within the borrowing powers of the company, and should make sure that it does not carry any higher rate of interest than would be ordinarily payable at the time.

(c) The auditor should see that such additional remuneration has been sanctioned by a special resolution of the company.

Q. 93. *In course of auditing, if you found that the managing agents had a current account with the company opened in their name, what inquiries will you make?*

For answer, see page 186.

Q. 94. *In the case of a Holding Company, upon what principles should the shares in Subsidiary Companies be valued, and how should these investments as also loans to Subsidiary Companies be stated in the Holding Company's Balance Sheet?*

A. Where shares are held by a Holding Company in its Subsidiaries, these are generally classed as Fixed Assets, and it is commonly held that a Holding Company cannot be compelled to provide for the depreciation in value of its share holdings in the Subsidiaries out of revenue, unless the Company's own Articles provide otherwise. On the other hand, where some of its Subsidiary Companies are making large profits and paying good dividends, whereas others are working at a loss, the shareholders of the parent Company are sure to be misled if no provision is made in respect of depreciation in the value of the shares held in the losing companies. From the viewpoint of sound finance and accounting, therefore, it may be laid down that if the financial position of the Subsidiary Companies at the date of signing the Holding Company's Balance Sheet is equal to or stronger than what it was at the time the shares were acquired, then such shares should appear on the Holding Company's Balance Sheet at actual cost. But if the financial position has become worse by reason of losses, incurred subsequent to the acquisition of the shares, then the value of those shares should be reduced by the amount of such losses, the corresponding debit being given to Profit and Loss Account.

The investments in and loans to Subsidiary Companies must be shown separately under their distinct heads in the Holding Company's Balance Sheet, and must not be mixed up with ordinary investments.

Q. 95. *Mention the provisions in the Companies Act, 1913, with reference to the appointment and remuneration of auditors.*

For answer, see pages 110-113.

Q. 96. *Set out the powers and duties of auditors under Section 145 of the Indian Companies Act, 1913, and the directions contained therein with regard to the auditor's report.*

For answer, see pages 226-232.

Q. 97. *What particulars are required to be entered in the Register of Mortgages and Charges, and what mortgages should be registered?*

A. In the Register of Mortgages and Charges should be entered a short description of the property mortgaged, the date of creation of such charge, the amount of the mortgage or charge created, the names of the mortgagees or persons entitled thereto, and the date such mortgage is redeemed.

Every mortgage or charge created in any one of the following ways must be filed with the Registrar of Joint Stock Companies within 21 days after the date of its creation:—

(a) a mortgage or charge for the purpose of securing any issue of debentures; or

(b) a mortgage or charge on uncalled share capital of the company; or

(c) a mortgage or charge on any immovable property wherever situate, or any interest therein; or

(d) a mortgage or charge on any book debts of the company; or

(e) a mortgage or charge, not being a pledge on any movable property of the company except stock-in-trade; or

(f) a floating charge on the undertaking or property of the company.

Q. 98. *While auditing the Balance Sheet of a Finance Company, you find that one of the assets is shown as "Investments including Government Securities and Railway Shares" in one amount of Rs. 20,50,000. On verification, you ascertain that a major portion of the amount is represented by Shares and Debentures in trading, industrial and other speculative companies, whereas only a small portion represents investment in Gilt-edged Securities. What should be your duty as an auditor under the circumstance?*

A. It will be the auditor's duty, in the above circumstance, to request the Directors to state the different types of Investments separately and clearly, in order that those reading the Balance Sheet may be better able to judge of their true nature. The New Form F of Balance Sheet requires that the investments in Government and Trust Securities should be distinguished from investments in shares, debentures or bonds, and the auditor should see that this is done. If his request in this direction is not complied with, it will be necessary for him to invite the shareholders' attention to the fact, either by qualifying his certificate accordingly at the foot of the Balance Sheet or

by means of a separate report. He should also see that all these investments have been brought down to their market value. If the directors have not done this on the argument that the fall in value is only of a temporary nature, the auditor should at least state their total market value as at the date of the Balance Sheet.

Q. 99. *The Directors of a Limited Company decide to provide for the redemption of an issue of Rs. 3,00,000 8% Debentures (repayable at par at the end of 20 years by one of the following ways :—*

(a) *By taking out a Capital Endowment Policy with an Assurance Company ; or*

(b) *By investing in gilt-edged securities annually a sum estimated to produce with compound interest the amount necessary to pay off the Debentures at their due date.*

You are requested to submit a Report placing before them the advantages and disadvantages of either of the methods.

A. To

The Board of Directors,
The Blank Company, Ltd.

Dear Sirs,

Having most carefully considered the two methods of providing for Redemption of Debentures in all their varied aspects as desired by you, I have pleasure in submitting my views thereon as under:—

(1) An advantage of taking out a Capital Endowment Policy with an Insurance Company will be that the amount payable as premium each of the twenty years will be definite and known, whereas if it is desired to set up a Sinking Fund invested in Gilt-edged Securities, an estimate will have first to be made of the interest that will be earned by such securities during the period of the Debentures, inasmuch as the Fund will have to be allowed to accumulate at compound interest. Besides, due to constant fluctuations in the market price of the securities, the total purchase price of the Investments cannot be definitely estimated from now.

(2) In case of a Capital Endowment Policy, the amount receivable on maturity will be definite, whereas the same cannot be said in regard to the Sinking Fund Method where the Securities will have to be realised to pay off the Debenture-holders, as the amount realisable must necessarily depend upon the then market value of those securities.

(3) On the other hand, if an occasion arose for the company to borrow money, a much larger sum can always be borrowed on gilt-edged securities than on a Capital Endowment Policy.

(4) On an occasion arising for the company to purchase its own Debentures in the market at a discount during the period of the Debentures, the Policy cannot be realised except at a loss.

(5) Where the Sinking Fund Method is followed, if it is found at any future time that the company has more than sufficient working capital and it is not necessary to provide any further sums out of profits and invest them specifically (assuming that the terms of issue of Debentures do not compulsorily require such a provision), the company can stop such further accumulation of funds. On the other hand, where a Capital Endowment Policy has been taken out, and if it is decided to discontinue the same before the expiration of the period by taking a Surrender Value, such a process will entail a heavy loss.

(6) Another argument that can be held out against a Capital Endowment Policy is that the total amount payable by way of premium will usually exceed the amount which is required to be invested under the Sinking Fund Method; but it may be that when the securities have to be realised for redemption purposes, the market conditions may be most unfavourable and the loss sustained on the sale of securities may outweigh the excess amount payable as premium.

After most critically examining the comparative advantages and disadvantages of both the methods abovesaid, I am inclined to believe that the advantages are in favour of the adoption of the Sinking Fund Method.

I beg to remain,
Dear Sirs,
Yours faithfully,

Q. 100. The following Balance Sheet has been handed to you for criticism by a client who is anxious to buy shares in the Company. Give your opinion in form of a letter :—

THE SWADESHI PRODUCTS, LTD.

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share Capital ..	3,00,000	Plant and Machinery, Loose	
Less Unpaid Calls ..	25,000	Tools, Furniture, Fixtures,	
	<u>2,75,000</u>	Motor Lorries and Horses ..	70,500
Debentures and Accrued Interest	40,000	Debtors and Debt Balances ..	75,300
Creditors and Credit Balances...	35,000	Stock, Work-in-Progress and	
Loans and Interest	15,000	Raw Materials, Stores, Pack-	
Profit and Loss Account	5,500	ing and Advertising Matter ..	20,000
		Investments and Loans and	
		Accrued Interest	70,000
		Freehold and Leasehold Pro-	
		perty and Goodwill	90,200
		Bills and Cash	44,500
			<u>3,70,500</u>
	Rs. 3,70,500		Rs. 3,70,500

A. Dear Sir,

With reference to the Balance Sheet of the Svadeshi Products, Ltd., handed over to us for criticism, we would like to point out that the same is too vague and uninformative for purposes of criticism, and unless some further information is forthcoming, we are afraid it will not be possible for us to submit anything like a useful opinion as to the true financial state of affairs of the company. We would like, however, to summarise its various shortcomings as under:—

(1) **Share Capital.**—The Authorised Capital as also the face value of the shares, and the extent to which the same have been called up should be mentioned. The number of shares in respect whereof there are calls in arrears, if any, should also be given.

(2) **Debentures and Accrued Interest.**—These two figures must be given separately and the rate of interest also must be mentioned, so that the period for which the Interest is outstanding can easily be ascertained. It should also be made clear whether the Debentures carry any charge, fixed or floating, on the assets of the company.

(3) **Creditors and Credit Balances.**—This is one of the most undesirable methods of stating liabilities in a Balance Sheet. The credit balances may include Cash Loans such as Bank Overdrafts, etc., which must be shown separately from Trade Creditors. They may also include any other liabilities such as outstandings for expenses, liabilities on Bills Payable, specific reserves for known losses such as depreciation, as well as general reserves for strengthening the financial position of the business. All these would need to be properly grouped and specifically shown.

(4) **Loans and Interest.**—Here again, the same considerations apply as in case of Debentures. The nature of the loan and the security given (if any) should be noted. The Interest outstanding should be stated separately.

(5) **Profit and Loss Account.**—Detailed information as to how this balance is arrived at is lacking to enable one to judge of the working results of the current year. Some information regarding the previous year's results may also become useful.

(6) **Freehold and Leasehold Property and Goodwill.**—Each of these should be shown separately at its original cost, less depreciation written off upto the date of the Balance Sheet. Different considerations regarding valuation apply to each of them, as one is a Fixed Asset, the other a Wasting Asset and the third an Intangible Asset, and due to lack of information as to the original cost and the depreciation so far written off each of these, it is not possible to judge as to how these have been valued. It is necessary to know the amount of Goodwill in order to form some opinion in its relation to the profit-earning capacity of the business.

(7) **Plant and Machinery, Loose Tools, Furniture, Motor Lorries and Horses.**—The original cost of each of these fixed assets should be stated separately less whatever depreciation has been written off on each of these. As they stand, it is not possible to determine whether any depreciation has been provided for or not. Particular enquiries will have to be made to ascertain the basis of valuation of Motor Lorries, Horses and Loose Tools.

(8) **Debtors and Debit Balances.**—What has been said about Creditors and Credit Balances may also be applied with equal force in this connection. This figure is likely to include items, such as Preliminary Expenses, Commission on Shares or any other fictitious and unrealisable asset. The Reserve for Doubtful Debts, if any, should be clearly stated. Debtors for advances and pre-payments should be separately stated.

(9) **Investments and Loans and Accrued Interest.**—Loans should be separated from Investments, and it should be ascertained whether Loans have been granted on any security or otherwise. There is a likelihood of loans being granted to some directors or officers of the company, in which case, the same are required to be stated separately. Interest accrued, again should be a distinct item. The nature of the Investments and the basis of valuation should also be clearly disclosed.

(10) **Stock, Work-in-Progress, Raw Materials, Advertising Matter, etc.**—Advertising matter should be separated from the rest of the items, as the same may include items of no realisable value to the business. The basis of valuation of stock of Finished Products, Raw Materials and Stores must be disclosed. The question of valuation of work-in-progress will have to be closely scrutinised.

(11) **Bills and Cash.**—These items should be separately stated one from the other, showing the exact amount of cash available. Enquiry must be made as to whether there is any reserve made for bills which may be doubtful.

In conclusion, we may state that the Balance Sheet fails in its entirety to fulfil the requirements under the Indian Companies Act, 1913, not only in regard to the Form but also in respect of the facts disclosed. It seems to have been prepared more with the object of holding back the necessary information rather than supplying the same. On receipt, however, of the information desired as above, we shall be pleased to submit to you a complete criticism of the financial position of the company.

Yours faithfully,

Q. 101. *Difficulties having arisen as to the proper ascertainment of "Net Profits" for the purpose of arriving at the 5% commission payable to the Managing Director over and above his fixed salary, you are requested to consider and report on the following :—*

- (1) *Whether his salary should be charged before arriving at the net profits ;*
- (2) *Whether depreciation should be brought into account ;*
- (3) *Whether expenditure incurred on removal and re-housing of a department of the factory should be charged ; and*
- (4) *Whether the Managing Director's Stock Valuation be accepted ?*

You are also asked to suggest what alterations in the agreement are desirable so as to avoid questions like these arising in the future.

A. Dear Sirs,

With reference to your letter inviting our opinion as to the proper interpretation of the term "Net Profits" for the purpose of calculating the Managing Director's commission and the treatment of certain items in connection therewith, we beg to submit our report as follows:—

(1) **Managing Director's Salary.**—This amount being a business expense should be charged in arriving at the "Net Profits."

(2) **Depreciation**, being a loss arising from the use of the assets in the conduct of the business, should be charged before arriving at the Net Profits, but this should be correctly calculated according to the nature of the assets concerned and the use to which the same are put.

(3) **Expenditure on Removal**, and re-housing of a department, although abnormal and of a non-recurring nature and not incurred in the regular course of the business, should be charged in arriving at the Net Profits for the purpose of calculating the commission. At most, it may be spread over a period of three to five years and a proportionate amount may be charged to revenue each of these years.

(4) **Managing Director's Stock Valuation.**—As regards the valuation of stock, it is preferable to have an independent valuation made by a person having no interest in the profits, rather than accept the Managing Director's valuation of this asset. If the latter is allowed to value the stock, the chances may be on the side of over-valuation, and this would tend to wrongly inflate the profits.

In order to avoid doubts on similar heads, in the future, the following alterations in the agreement seem to us to be necessary:—

(1) The term 'Net Profits' should mean 'Net Trading Profits', i.e., profits earned in the carrying on of the business as such, and must necessarily exclude any income from such items as Investments, the holding of which does not form a part of the ordinary trading operations, or profit arising from the sale of any fixed asset.

(2) Provision should be made for the valuation of stock by an independent person, and it is desirable that the general basis of valuation be laid down, such as cost or market price whichever is lower.

(3) Extraordinary expenses, i.e. expenses incurred out of the regular course of business, should be excluded while arriving at the Net Trading Profits, as for example, expenditure on removal of business, loss arising from under-insurance, etc.

(4) All revenue expenditure incurred during the period in the ordinary course of business should be charged, despite the fact that a part of the same is to be treated as Deferred Revenue Expenditure for some other reasons.

(5) It should be clearly mentioned whether any kind of tax (whether present or future) is to be charged while arriving at the Net Profits.

(6) All items of capital profits should be excluded.

(7) It would seem desirable and advantageous to have an arbitration clause inserted in the agreement to the effect that in case of any doubt or disagreement as to the correct interpretation of any clause, the auditor of the company for the time being should be the sole Arbitrator in the matter, and his decision shall be final and conclusive so as to bind both the parties.

We beg to remain;

Dear Sirs,

Yours faithfully,

Q. 102. *The Promoters of a company having agreed to bear all the Preliminary Expenses, you are requested, as an auditor to the company, to determine the amount. What items would you include in this account?*

A. The following items would be included under the heading "Preliminary Expenses", which are recoverable in this case from the promoters:—

(1) Registration Fees and Stamps on preliminary contracts with the vendors.

(2) The legal costs in connection with the preparation of the Memorandum and Articles of Association, Prospectus and Contracts, and Registration of the Company.

(3) Cost of printing the Memorandum and Articles of Association.

(4) Cost of printing, advertising and issue of Prospectus.

(5) Accountants' and Valuers' charges for report, Certificate, etc.

(6) Cost of printing and stamping application forms and letters of allotment.

(7) Cost of printing Share Certificates, and

(8) Cost of Statistical and Statutory Books.

Underwriting commission and commission on placing shares cannot be included in the Preliminary Expenses, as according to the present Act, they are required to be shown separately.

Q. 103. *A Limited Company, having a large surplus Bank Balance, purchased Rs. 4,50,000 worth of Government Securities at 85. At a later date Rs. 1,50,000 was sold at 80 and at the date of the Balance Sheet the market price was 87.*

The Balance Sheet shows the item as "Investments in Government Securities of Rs. 3,00,000 = Rs. 2,62,500."

What would be your duty in regard to this item ?

A. The effect of dealing with the Investment Account in this manner is to add the loss of Rs. 7,500 arising from the sale of Rs. 1,50,000 worth of securities to the cost of Rs. 3,00,000 worth remaining unsold, which is equivalent to valuing the unsold portion above cost. This should not be done, and the loss of Rs. 7,500 should be written off to revenue. The balance of unsold securities should be brought down at cost price, viz., 85, and would appear in the Balance Sheet at that figure. If the directors do not see their way to alter the Balance Sheet accordingly, the auditor should report the matter to the shareholders.

The auditor should vouch the purchase and sale of the securities by examining the broker's Bought and Sold notes, and should verify the market price at the date of the Balance Sheet by reference to the official quotation.

Q. 104. *Detail the special points that would require your attention in auditing the books of a Colliery Company.*

A. The following are the principal points in the audit of a Colliery:—

(1) See that the allocation of expenditure on wages, stores and materials between Capital and Revenue is properly made.

(2) The system of preparing Wages Sheets and of paying Wages must be carefully enquired into and it should be seen that all deductions are properly dealt with. Vouch wages with Wages Books, seeing that they are properly certified, and check a certain proportion of casts and extensions.

(3) Inspect Leases and Output Books for minimum or dead rent, royalties, short workings, etc., and see that no short workings are improperly carried forward.

(4) See that the Development Accounts are written off over the term during which they are expected to prove fruitful. Particularly see that all pit timber, which is very perishable, is charged against Revenue as used, unless there is some sound reason for the expenditure being carried forward.

(5) Check the accounts relating to waggons on hire purchase, and see that the proportion of each instalment representing Interest is charged to Profit and Loss.

(6) Ascertain that proper provision is made for depreciation of plant, tram lines, etc.

(7) See that all outstanding liabilities and Railway accounts are properly brought into account.

(8) See whether it is necessary to provide for depreciation of the leasehold, or for the exhaustion of the freehold, and if provision is made, see that it is made in the case of leasehold according to the term of the lease, and in the case of freehold in proportion to the output during each period.

Q. 105. *Extensive thefts are committed in the wages or cash sales of an undertaking, and they are not discovered by the auditor. Under what circumstances, if any, can the auditor be held responsible, in the event of the subsequent discovery of the thefts?*

A. An auditor being an agent of the shareholders is presumed to bring reasonable skill and diligence to bear upon the work which he is employed to do. If, therefore, he is guilty of negligence in the execution of his duty, he may be held liable to make good any damage resulting from such negligence. This liability arises under the ordinary law of contract, and the question as to whether the auditor is subject to it in any particular case, will depend entirely upon the circumstances.

Where an auditor finds on enquiry that there is nothing like an efficient system of internal check in force in relation to the preparation and payment of wages, or in the record of cash sales, and that the existing system is full of loopholes for fraud and errors, he should report to his clients the danger that exists, and suggest remedies to improve upon the present system. If his suggestions in this direction are not carried out, he should definitely state that he cannot be held responsible for any irregularities that may occur. In case of a Limited Company, he would protect himself still better by reporting such a state of affairs to the shareholders. If, subsequently, frauds take place, the auditor is in a very strong position, and unless there has been manifest negligence on his part, he cannot be held responsible.

Where there is a good system of internal check in operation and the auditor has exercised reasonable skill and care in testing the transactions, he should be under no liability. The whole question will hinge upon whether or not the auditor had been negligent having regard to the facts of the case. Even if he has been negligent, he can only be held responsible to the extent of the direct damage resulting from such negligence.

Q. 106. *Discuss the question whether an auditor of a Limited Company should challenge an under-valuation of assets just as much as an over-valuation.*

A. The main duty of an auditor before certifying a Balance Sheet is to see that all the assets and liabilities as embodied therein are properly brought in and valued; i.e., they are neither over-stated nor under-stated or ignored.

An over-valuation of assets would make the position of the concern according to the Balance Sheet appear better than what is really the case, and consequently, it should be immediately challenged by the auditor.

An under-valuation of assets, on the other hand, will have the effect of creating a Secret Reserve, since the actual position of the company will be really better than as appearing from the Balance Sheet. The duty of the auditor in connection with this question and the attitude which he might find it necessary to take up must be determined by the facts of each particular case. If he is of opinion that the assets are being under-stated for a *bona fide* purpose and in the best interests of the company generally, he need not take objection to it, and will only refer to the matter in his Report to the Shareholders, if the amounts involved are so considerable as to render it necessary.

If, however, he finds that the assets have been under-valued by those in management for the purpose of manipulating the profits improperly for their own personal ends, or that the Secret Reserve is utilised for considerably augmenting the profits so as to give the shareholders a mis-impression as to the true working results, he should certainly deal with the matter in his report to such an extent as he thinks desirable.

Q. 107. *To what special points would you direct attention in the audit of an Electric Lighting Company?*

A. The auditor should direct attention to the following special points in the audit of an Electric Lighting Company:—

(1) See that the accounts are made up in the form prescribed by the Indian Electricity Act.

(2) The income should be vouched by testing the Consumers' Ledger with meter books, register of fittings on hire, Consumers' Day Book, etc.

(3) The agreements with customers for supply on special terms, or any contracts with local authorities for public lighting should be examined.

(4) The allocation of expenditure as between Capital and Revenue should be closely scrutinised, and it should be seen that the allocations are duly certified by the Chief Engineer.

(5) See that all Repairs and Renewals are charged to Revenue.

(6) See that adequate depreciation is provided in respect of the different assets.

(7) Verify all additions to assets carefully to see that they really represent capital expenditure.

(8) Ascertain that the stock of stores, etc., is duly certified and properly valued.

Q. 108. *In the annual Balance Sheet of a Limited Company, the creditors were under-stated as a result of the goods purchased not having been entered in the Purchases Book, though the goods were*

included in the stock. Could an auditor, under such a circumstance, be held responsible for not discovering the omission? Give reasons for your reply. What checks can an auditor apply to avoid such errors?

A. Where the creditors of a company happen to be under-stated in consequence of the goods purchased not having been brought into the Purchase Day Book though they were included in the stock, the auditor might be held to be responsible, if it is proved that by the exercise of reasonable skill and diligence, he could have discovered the omission.

In the case of the *Irish Woollen Co. Ltd. vs. Tyson and others*, the auditor was held liable for the damages the company had sustained from the under-statement of liabilities in the Balance Sheet due to this cause, the Irish Court of Appeal holding that both the suppression and carrying over of invoices would have been detected, if the auditor had called for the creditors' statements of accounts upon which payments were ordered, and compared them with the Ledger.

The checking of the Creditors' statements will no doubt help to trace omissions of this character, and this can be supplemented by an examination of the Goods Received Book for the period prior to the date of the Balance Sheet for the purpose of ascertaining whether the goods that had been received during the last few days were included in the purchases.

It is also desirable to obtain a certificate from a responsible official that all known outstanding liabilities in regard to purchases have been brought into account.

Q. 109. *In March 1938, the Indian Finance and Agency Company, Limited, underwrite an issue of 1,50,000 5 per cent Preference Shares of Rs. 10 each of the National Trading Company, Ltd., for a commission of 5 per cent. As a result of the issue they have to take up 75,000 shares.*

In September 1938, they sell 10,000 shares at Rs. 12|8 per share net.

In November 1938, they sell 15,000 shares at Rs. 9|8 per share net.

On 31st December 1938, at which the accounts of the Company are made up, the market price of these shares is Rs. 8|8 per share.

On what principle should the above transactions be dealt with in the Balance Sheet and Profit and Loss Account of the Finance Company?

A. The shares taken up under the underwriting contract should be debited at cost price to an Investment Account, which account should be credited with the 5 per cent underwriting commission. This account should also be credited with the sales as made, and as the company is evidently

intending to sell the shares, the balance on hand at the date of the Balance Sheet should be brought in at the market price. The account will appear as follows:—

NATIONAL TRADING CO. LTD. SHARES

1938	Shares.	Rs.	1938	Shares.	Rs.
March To Sundries	75,000	7,50,000	May By Underwriting		
Dec. „ Profit			Commission		75,000
and Loss			Sep. „ Bank	10,000	1,25,000
Account		17,500	Nov. „ „	15,000	1,42,500
			Dec. „ Balance c'd	50,000	4,25,000
	<u>75,000</u>	<u>Rs. 7,67,500</u>		<u>75,000</u>	<u>Rs. 7,67,500</u>
1939					
Jan. 1 To Balance b'd	50,000	4,25,000			

Q. 110. You are asked by the Executors of the estate of a deceased person to audit the accounts at the end of the first year. State what documents and papers you would require in addition to the Books of Account and how you would proceed to carry out your duties.

A. In auditing the accounts of the estate of a deceased person at the end of the first year, the following documents and papers would be required in addition to the books of account:—

(1) Probate of the Will, in order that the provisions affecting the accounts and the creation of separate trust funds can be noted.

(2) Estate Duty affidavits and corrective affidavit, if any, in order to ascertain that all the assets and liabilities left by the testator have been brought into account.

(3) Copy of Residuary Account in order to ascertain that the total amount of residue is accounted for.

(4) Brokers' Contract Notes to vouch the purchase and sale of gilt-edged securities and other investments.

(5) Auctioneers' Accounts to vouch proceeds from sales of property.

(6) Vouchers for Cash Payments.

(7) Counterfoils of Dividend Warrants in order to vouch dividends received.

(8) All documents of title such as certificates of stocks and shares held, title deeds, etc. in order to verify the existence of the assets.

(9) Pass books and paying-in books to verify the transactions with the Bankers and the Bank Balance.

(10) Certificate of Bankers as to the Bank Balance.

Q. 111. *On September 30th 1938, a Tin Plate Manufacturing Company contracted to buy 500 tons of tin at Rs. 1,500 per ton, for delivery December 31st 1938. A few days later they contracted to sell 100 tons at Rs. 1,550 also for delivery December 31st 1938. The accounts are made up to October 31st 1938, and you find that Profit and Loss has been credited with the profit in respect of these transactions. Would you pass the item as correct? If not, state your views.*

A. The profit on these transactions should not be brought into credit in the Profit and Loss Account for the period ending 31st October 1938, since the transactions are for future delivery and would not be completed till 31st December 1938. Even on that date, the transactions may result in a gain or a loss, since in order that the profit can be actually cleared, it is necessary for both the buyer and seller to fulfil their contracts.

If the directors persist in taking this profit, the auditor should refer to the matter clearly in his report.

Q. 112. *Assuming the following facts, and that the Board of a Cigarette Manufacturing Company declined to amend the figures of the Balance Sheet presented to you for audit, what observations, if any, would you make thereon in your "Report to the Shareholders"?*

(1) *The Subscribed Capital was Rs. 5,00,000 all called up, but Rs. 1,00,000 thereof was represented by "Calls in Arrear", all due from Directors.*

(2) *The "Stock of Tobacco" was valued at the market price at the date of the Balance Sheet, which was in excess of the actual cost.*

(3) *No reference was made to "Bills under Discount".*

A. Calls due by Directors will have to be stated specifically on the face of the Balance Sheet. If the Directors have not paid their calls at the date of audit, and the fact is not shown on the Balance Sheet, the attention of the shareholders should be called to the matter by the auditor in his report. He should also report on the fact of the Stock of Tobacco having been valued at market price which happened to be higher than the cost.

As to the Bills under Discount, if any loss is anticipated, this should be provided for, otherwise a note should be made at the foot of the Balance Sheet about the contingent liability in respect of Bills under Discount. If the directors decline to admit this note, the matter should be referred to in the report.

Q. 113. *Under what circumstances would you, as auditor, consider it necessary to insert special clauses in your report to shareholders of a Public Company registered under the Indian Companies Act, 1913? Give three examples.*

A. Where a difference of opinion has arisen between the auditor and the directors as to the treatment of certain items in the accounts, or the correctness of the Balance Sheet, and the directors do not see their way to amend the accounts as the auditor may desire, the latter must qualify his report accordingly.

The following are three instances:—

(1) A considerable quantity of cotton has been taken into stock at market price, which is in excess of cost price.

(2) No provision has been made for depreciation of leasehold premises and plant and machinery.

(3) The Bankers hold a Floating Charge on the Company's Stock-in-trade as a security against Overdraft, a fact not disclosed in the Balance Sheet.

In each of these cases, the auditor should refer to the matter in his report.

Q. 114. *The market price of Copper has fallen very heavily in value during the last few weeks of the year, and on 31st December is 20 per cent below the average price of the year. A firm, whose manufacture is exclusively of copper goods, has contracts running for the delivery of copper to it at prices considerably above the market quotation of 31st December, and has also on hand a large stock of raw material and finished and partly-finished goods. They ask your advice as to the proper basis on which to value on 31st December:—*

(1) *Their stock of raw material ;*

(2) *Their stock of finished goods ; and*

(3) *Their stock of partly-finished goods.*

State what you would advise under each head, and your reasons for such advice.

A. (1) **Raw Material.**—As the market price has fallen 20% below the average price for the year, if by the date the accounts were prepared it has not subsequently risen, and shows no likelihood of doing so, stock of raw materials should be written down to the market price.

(2) **Finished Goods.**—Similar remarks apply in this case, but if the firm has contracts running for the sale of such goods based upon the higher price of copper, there would be no reason to reduce the price below cost provided the stocks are not in excess of the goods required to fulfil the contracts in question. Otherwise, such proportion of the value of the goods as is represented by the copper consumed should be reduced correspondingly.

(3) **Partly-Finished Goods.**—The same remarks apply here as in the case of Finished Goods.

As there are forward contracts for the supply of copper at the higher rates, there is an outstanding contingent liability at the date of the Balance Sheet in respect thereof. If it is not desired to provide for this in the current year's account, a note should be made on the Balance Sheet to the effect that such a contingent liability exists.

Q. 115. Give instances of "Contingent Liabilities" and state how they should be dealt with in a Company's Accounts. What should be your duties as an auditor in connection with such liabilities?

A. Contingent Liabilities are liabilities which have not arisen or have already accrued, but may arise out of transactions pending, upon the happening of a certain event. Thus a contingent liability may or may not involve the payment of money.

Among instances of Contingent Liabilities may be quoted:—(1) Liability for Calls on partly-paid shares held; (2) Liability on Bills Receivable discounted and not matured; (3) Liabilities under a Guarantee; (4) Liabilities for Penalties under Contracts; (5) Liabilities for claims under dispute; (6) Liability in respect of arrears of dividend on Cumulative Preference Shares.

While preparing a Balance Sheet, only the liabilities that have actually accrued due to the date of the financial close should necessarily be brought into account. The Form of Balance Sheet prescribed under the Indian Companies Act, however, requires that Contingent Liabilities should be stated in shape of a note appended to the Balance Sheet, at the foot of the liabilities side.

An auditor should therefore ascertain if there are Contingent Liabilities coming under any of the above heads, and, if so, he should see that they are clearly set out at the foot of the Balance Sheet by way of a note.

Q. 116. Included amongst the assets of a Weaving Mill are 200 Looms in use which appear in the books of the company at the present depreciated value of Rs. 750 each. All repairs and replacements of worn-out parts have been charged to revenue during the years they were in use. In view of the fact that new Looms of similar make can now be purchased for Rs. 550, would you as an auditor call upon the directors to reduce their book value to this figure?

A. To a manufacturing company, Looms are of the nature of Fixed Assets, and, having due regard to this fact, their book values should not in any way be affected by market fluctuations. As the company had acquired these by way of equipment and not with a view to resale, the Balance Sheet values each year represented their original cost less such wear and tear as they were deemed to have suffered due to the use they were subjected to, in order that the original cost of the asset may be spread equitably over its estimated

working life to the business as a going concern. The auditor therefore need not concern himself with the fall in market value of the Looms as long as a reasonable percentage of depreciation is written off against the revenue each year.

Q. 117. *What instructions would you leave for the guidance of the Head Accountant of a Limited Company to enable him to keep everything in readiness for audit purposes?*

A. The following instructions may be advantageously given to the Head Accountant in connection with the audit of the books of account of a Company:—

(1) In case of the first audit, a complete list of books of account should be furnished together with a statement showing how the duties of the accounts staff are divided. A description should also be given of the internal check, if any exists.

(2) All credit purchases and sales must be supported by Inward and Outward Invoices, which should be consecutively numbered, and so filed as to be readily available for reference.

(3) All Returns of Goods inwards and outwards must be evidenced by their corresponding Debit and Credit Notes.

(4) All counterfoils of Receipts should be kept ready in order of dates.

(5) A Bank Reconciliation Statement should be made out showing the agreement of the Bank Balance with the Cash Book.

(6) The Cash Book should be balanced and the balances carried down in ink. Similarly, the periodical totals of all the subsidiary records should be written out in ink.

(7) Every item of payment must be substantiated by a proper voucher, that is, an acknowledgment by the payee showing distinctly the amount received by him and the reason of such payment.

(8) All such vouchers must be numbered consecutively and arranged in the order in which the payments are recorded in the Cash Book, and the corresponding numbers must be shown against their respective entries in the Cash Book to facilitate reference.

(9) Where original vouchers cannot be obtained in support of certain payments, as for instance, Travelling Expenses, Cartage, etc., detailed statements must be prepared of these, and got initialled by some authorised person.

(10) All Journal entries in respect of adjustments or transfers of accounts must be supported by proper documentary evidence.

(11) All Ledger Accounts must be closed and the balance, if any, on Personal Accounts and Accounts of Assets and Liabilities must be carried down in ink.

(12) Schedules should be prepared of the balances of Debtors and Creditors on Open Accounts showing how the total corresponding figures in the Balance Sheet are arrived at.

(13) A separate List should be prepared of Debts considered Doubtful so as to enable the auditor to judge of the adequacy of the Reserve in this connection.

(14) Separate Lists should also be made of all Outstanding Liabilities, Pre-payments, Accrued Income and Income received in Advance, if any.

(15) All Bills Receivable on hand must be kept ready for inspection or a letter should be obtained from the Bankers to the effect that they were in their possession at the date of the financial close for purposes of collection.

(16) A list should be made of all Bills Payable not due.

(17) Where there are several investments, a List of these should be prepared showing how the Balance Sheet figure is arrived at, and what the basis of valuation is.

(18) All Contracts, Title Deeds and similar other documents should be kept in readiness for inspection.

(19) The Trial Balance should be agreed.

(20) A draft copy of the Trading and Profit and Loss Account and Balance Sheet signed by the Accountant should be kept ready.

Q. 118. *In what circumstances would you as an auditor allow expenditure incurred under the following heads to be capitalised, viz., Interest on Capital, Carriage, Repairs, Wages, Legal Charges and Brokerage?*

A. Interest on Capital.—Where the share capital is raised for the purpose of construction of works such as a new Railway System or Canal Works, etc., which would take a number of years to complete before revenue-earning stage is reached, Interest can be paid on such capital during period of construction, under certain terms and conditions, and the same can then be capitalised and added to the cost of construction.

Carriage.—Carriage inwards paid on purchase of plant, furniture, etc., can be capitalised and treated as additional cost of acquisition.

Repairs.—Where on acquisition of a second-hand machine an amount has to be expended by way of repairs to put it in working order, or where a building acquired is in a dilapidated condition and amounts have to be expended thereon to put it in a tenable condition, such repairs are allowed to be capitalised.

Wages.—Wages paid to workmen for manufacturing tools or for erection of plant or for extension to works building can be capitalised.

Legal Charges.—These incurred in connection with conveyance of landed properties acquired can be capitalised.

Brokerage paid on purchase of a property or any other fixed asset or investments is capitalised.

Q. 119. *At a general meeting of shareholders, you are questioned as to why you should have signed the Balance Sheet when all the assets indicated therein are not shown at their realisable value. What should be the nature of your reply ?*

A. A Balance Sheet may be defined as a statement prepared with a view to measure the exact financial position of a business on a certain fixed date. The chief object in preparing it should be to disclose all the information necessary to enable one to form a true estimate of the financial position of the business as a going concern. A Balance Sheet is not drawn up with a view to show what the capital of the concern would be worth if the assets were realised and the liabilities paid off, but rather to show how the capital stands invested at the end of each financial period. The values in the Balance Sheet are therefore not break-up values, but are ascertained on the assumption that the business is not to be wound up in the near future but will continue to run its normal course.

Thus, whereas fixed or permanent assets are unaffected by market fluctuations and are always valued from the standpoint of their utility to the concern owning them, the values of floating or circulating assets are always modified by market fluctuations, for the reason that as these are liable to be converted into cash at the earliest possible opportunity, they should not be assessed in the Balance Sheet at anything more than they are likely to realise, even though they may have cost more.

Besides, there are several items on the assets side of a Balance Sheet which represent Revenue Expenditure and yet are not charged off to revenue in their entirety in the year in which they are incurred, but are held over for a certain number of years as they have a value to the business as a going concern, although they cannot be deemed to have any saleable value if the company went into liquidation.

So long as, therefore, all the liabilities existing at the date of the Balance Sheet are clearly set out under their distinctive heads, and all the various items composing Fixed, Floating and Intangible or Fictitious Assets are shown under their appropriate heads, and so long as these are valued on basis generally accepted as sound and correct, a Balance Sheet would be deemed to have been properly constructed, so as to reflect the true financial condition of the business.

Q. 120. *Where any asset has been acquired by your clients on the Hire-Purchase System, to what particular points would you, as an auditor, pay attention ?*

A. (1) It should be seen that the asset is brought into record at its present value, (i.e., cash basis) and the additional amount resulting on account of deferred payments is charged to Interest Account.

(2) The whole of the Interest as represented by the difference between the total payments agreed to be made and the present cash price of the asset should not be charged off to Interest Account in the first year, but should be temporarily debited to Interest Suspense Account, and a proportionate amount of interest applicable to each year should be written off to revenue in that year.

(3) The calculation of the annual depreciation should be based on the cash price of the asset and not on the total instalment value.

Q. 121. *The following Balance Sheet of a Patent Medicine Company is placed before you for criticism and you are asked to comment upon its deficiencies :—*

BALANCE SHEET

Share Capital :	Rs.	Rs.	Purchase Account, Goodwill, etc.	•Rs.
Preference Shares	2,50,000			.. 4,00,000
Ordinary Shares	3,50,000		Patents & Fees Paid	.. 50,500
		6,00,000	Experimenting Account	.. 42,800
Debentures		1,00,000	Special Advertising Account	.. 30,600
Credit Balances		2,57,900	Furniture and Fixtures	.. 3,500
			Debit Balances	.. 2,50,000
			Investments	.. 75,000
			Cash at Bank	.. 80,500
			Profit & Loss Account	.. 25,000
				<hr/>
		Rs. 9,57,900		Rs. 9,57,900

A. Share Capital.—The authorised and issued capital as also the face values of Ordinary and Preference Shares must be indicated. The percentage of Preference Shares Dividend must also be stated. Shares if issued for consideration other than cash should be separately stated.

Debentures.—The rate of interest and the interest outstanding must be clearly stated. It is not clear whether the Debentures carry any mortgage or charge on the assets of the company.

Credit Balances.—This amount must be distinguished between:—

- (a) Creditors on Open Accounts;
- (b) Bills Payable;
- (c) Creditors for Loans; and
- (d) Creditors for Outstanding Expenses.

If the credit balances include any specific reserves for estimated losses, they should be shown by way of deduction from the respective assets. Simi-

larly, if there are any funds representing undistributed profits, they should be shown under their distinct heads.

There does not seem to be any sound reason why the creditors should stand at a large figure having due regard to the fact that there is a big Bank balance over and above the investments.

Purchase Account, Goodwill, etc.—Evidently, the item Purchase Account would be including the Fixed Assets which should all be shown separately under their appropriate heads. It is not clear whether any depreciation has been written off those or they appear at cost. They should all be shown at their original cost *minus* such depreciation as would represent the actual wear and tear. Goodwill should be shown as a separate item at cost.

Patents and Fees Paid.—The amounts paid for Patents must be spread equitably over the number of years for which the patents are to run. The depreciation should be shown as a deduction from the cost distinctly in the Balance Sheet. Patent Fees should be charged off to revenue.

Experimenting Account.—It is not desirable to permanently capitalise such a large sum unless the amount expended is expected to result in new Patents being secured. Even in such a circumstance, the cost of experimenting should be distributed over the period of years the business is likely to benefit thereby and a proportionate amount should be charged off to revenue.

Special Advertising Account.—Evidently, this is an abnormally heavy amount expended with a view to advertise new products. The item should be spread over a reasonable number of years, say 2 to 3, which are likely to benefit from such an expenditure, by charging proportionate amount to revenue each of these years.

Furniture and Fixtures.—The item must be shown at cost less depreciation.

“ **Debit Balances.**—This figure must be split into—

- (a) Debtors on Open Accounts;
- (b) Bills Receivable; and
- (c) Debtors for Loans.

The provision for Doubtful Debts should be shown separately on the liabilities side under its distinct head.

If the Debit Balances include any items of Deferred Revenue Expenditure such as Preliminary Expenses, Underwriting Commission or Cost of Issue of Debentures, they should be shown under their distinct heads.

Investments.—The nature of the investments and the basis of valuation must be clearly stated. Investments in gilt-edged securities should be distinguished from investments in shares, stock or debentures.

Cash at Bank.—Being a large sum, it is presumably made up of cash on Deposit Account and cash on Current Account. If so, these should be separately stated.

Q. 122. *The Directors of an Engineering Manufacturing Company seek your advice upon the correct allocation between capital and revenue of certain expenditure as follows :—*

Due to obsolescence, a portion of the plant used in the works has had to be replaced by entirely new plant. Part of the new plant was purchased and part was manufactured in the works. The pulling down of the old plant and the erection of the new was carried out by the company's own men. How would you make the apportionment ?

A. All the amounts expended in shape of materials, stores and wages should be most carefully analysed. The wages spent on pulling down of the old plant should be separated from the wages expended on the manufacture and erection of the new.

The cost of materials consumed from stores and those specifically acquired should also be ascertained.

The amount realised on sale of old plant and materials should be credited to the Plant Account. The amount of depreciation so far provided for and attributable to the portion of plant discarded, if standing on a separate Depreciation Fund Account, should now be credited to the Plant Account. The difference between the book value of the obsolete Plant and the amount realised on sale of scrap should be transferred to a special account headed 'Cost of Replacement of Plant Account.' To this same account should be charged the wages expended on pulling down.

The cost of materials used from stores and those purchased, as also the wages expended on the manufacture and the erection of the new plant should be debited to New Plant Account.

The Cost of Replacement of Plant Account representing an abnormally heavy loss of a non-recurring nature should be treated as an item of Deferred Revenue Expenditure and spread over a period of 3 to 5 years. The balance not written off should in the meantime appear under its distinct head on the assets side of the Balance Sheet.

Q. 123. *While auditing the books of a company, you find that as a result of revaluation of Land and Buildings, the asset account has been debited with the excess value thus ascertained and the corresponding credit has been given to Profit and Loss Account. How would you deal with such a circumstance ? What would you do if the revaluation figure did not come up to the book value ?*

A. If on enquiry it is ascertained that the difference is not due to any rise in the market value but is the outcome of excessive depreciation having been written off in the past, the auditor can have no objection to the asset account, being adjusted and the credit being taken to the Profit and Loss

Account. The result in this case would be to set right more than necessary depreciation having been provided in the past.

In the absence of the above state of affairs, an unrealised profit arising from the revaluation of a fixed asset is a capital profit not available for dividend, and the same cannot be transferred to Profit and Loss Account. If, therefore, the directors refuse to have the accounts modified, the auditor will have to call the attention of the shareholders to this fact in his report.

If the revaluation results in indicating that the present book value of the asset is more, this may be due either to under-depreciation in the past or fall in market value. If the latter is the case, the book value of a fixed asset need not be affected by market fluctuations, and the auditor will have no reason to bring this fact to the shareholders' notice as long as he is satisfied that a reasonable percentage of depreciation is written off the cost from year to year. On the other hand, if such loss is the outcome of inadequate depreciation in past years, the auditor must necessarily see to the asset account being toned down in value, or otherwise he must qualify his certificate accordingly.

Q. 124. **A Limited Company has made sufficient profits to enable it to declare a dividend, but due to the small existing Bank Balance, the dividend cannot be paid. Your advice is sought as to how to raise money for this purpose.*

A. In the absence of any Balance Sheet being placed before us, it is not possible to know whether any investments by way of gilt-edged securities are held by the company, for, if so, these may be realised in order to secure the cash necessary for the payment of the proposed dividend.

If the shortage of Bank Balance arises from a temporary dislocation of funds due to the Stock-in-trade or Book Debts being extensively heavy, the present difficulty can be got over by arranging an Overdraft with the Bankers. The dividend can then be paid out of the cash amount thus rendered available, and the Bank Overdraft can be repaid so soon as the Stock and Book Debts are realised. It may, however, be pointed out that it would not be advisable for the Directors to have recourse to such a measure unless they see any reasonable probability of the company being soon able to repay such overdraft. In the absence of this circumstance, it would seem advisable that the profits be not distributed, but held over so as to constitute a Reserve Fund which may serve as more working capital and may be helpful in the future when similar circumstances arise.

The very fact that the company finds itself short of Bank Balance despite a profit having been made serves to signify that the company is hampered for want of sufficient working capital. If the nature of the company's business is such that any additional share capital can be advantageously utilised to extend the company's business and co-extensively enhance its profit-earning

capacity, it would be advisable to issue further shares to the existing shareholders, who would evidently be found willing to put in more money in such a profitable concern. But this would constitute a permanent addition to the share capital and a constant burden on the company in shape of dividends to be payable, and unless the moneys received can be beneficially utilised as abovesaid, it would not be desirable to over-capitalise the concern.

Another alternative that may be suggested in this direction would be to secure the necessary amount by issuing short-termed Debentures, but this procedure would entail a burden in shape of interest payable to the Debenture-holders. At the same time, the Directors must resort to this method of raising money only provided they are quite confident that the company would be in sufficient funds at the time the Debentures become repayable.

One more alternative would be not to pay the current dividend in cash, but in shape of partly-paid Bonus Shares. Such a procedure will, on the one hand satisfy the shareholders, and at the same time, prevent the company from parting with its cash resources. Besides, the remaining Call if made on these shares will serve to supply the company with the necessary working capital which it seems to be in need of.

Q. 125. *A manufacturing Company which has a large Reserve Fund amounting to Rs. 20,00,000 represented by gilt-edged securities, has made a net profit of Rs. 10,000 only due to a prolonged strike on the part of the workmen. The usual dividend which it has been paying in the past ordinarily consumes Rs. 60,000, and the Directors propose to equalise dividends by drawing Rs. 50,000 from the Reserve Fund. It is proposed by the Board that such amount be transferred to the Profit and Loss Account. What would be your position as an auditor ?*

A. Ordinarily, the Reserve Fund is meant with a view to equalise dividends, and there can, therefore, be no legal objection to the directors falling back upon this Fund to enable them to pay the usual dividend as hitherto. In order, however, that there may be no misconception in the minds of the shareholders, it is necessary to see that the transfer from the Reserve Fund is not credited to Profit and Loss Account but to Profit and Loss Appropriation Account. The fact that the Reserve Fund has been drawn upon for the purpose of equalising dividends must be made clear on the face of the accounts. If the directors refuse to act accordingly, the only duty of the auditor would be to bring this fact to the notice of the shareholders by means of a note to that effect in his certificate or a separate Report.

Q. 126. *A prospective purchaser of a manufacturing concern wishes you to investigate into the Accounts and report thereon. The profits for the last three years of the business are as follows :—*

				Rs.
First Year	..	..	..	1,20,000
Second Year	..	..	..	80,000
Third Year	..	..	..	1,70,000

On comparing the Profit and Loss Account of the last year with that of the previous year, you find that the increase in the last year's profit is apparently due to the following facts among others :—

				Rs.
(a) Decrease in Expenses	..	..	..	35,000
(b) „ in Bad Debts	..	..	..	14,000
(c) „ in Depreciation	..	..	..	9,500
(d) „ in Interest Paid	..	..	..	6,000
(e) Increase in Sales	..	..	..	25,500
(f) Decrease in Returns Inwards	..	..	..	8,000

What steps would you take to satisfy yourself as to the correctness of the figures placed before you on behalf of your client ?

A. (a) Decrease in Expenses.—In view of the fact that the sales of the last year show a considerable increase, this large decrease in the trade expenses seems rather out of the ordinary. The auditor in this connection should compare each item of expenditure separately with similar item of the previous year to ascertain if any item of expenditure has been altogether omitted. He should then take note under which heads less amount has been expended than in the preceding year, and enquire into the cause of this reduction. It may be that some of the business expenses may have been debited to Drawings Account of the proprietor with a view to inflate the profits. He should carefully scrutinise items like Travellers' Commission, Travellers' Expenses, to see if all outstandings in this connection have been brought into account. The question of all outstanding liabilities in respect of other expenses incurred and not paid for should be thoroughly investigated. The auditor should then very carefully scrutinise the provisions made in respect of Doubtful Debts, Discounts and Allowances, etc., and see how they compare with similar provisions made in the previous years, as also whether they are adequate in the light of the facts before him.

(b) Decrease in Bad Debts.—For this purpose, the auditor may do well to go through the list of Debtors' balances as brought out from the Customers' Ledger with some responsible person, and ascertain whether all debts proved to be bad and irrecoverable have been actually written off. If not so written off, he should see if these have been included in the list of Doubtful Debts. The list of Doubtful Debts should also be gone over to see how the total of this list compares with the provisions actually made in respect of Doubtful Debts, in the previous year. The actual fall in Bad Debts in the last year may be accounted for by some extraordinary large Bad Debt, having been

written off in the previous year. In view of the fact that Bad Debts have a direct bearing on the sales, Bad Debts in the third year should have been more than those of the previous years. The Debts classed as good should also be critically examined to see if they are really recoverable, and they do not exceed the term of credit ordinarily allowed by the business.

(c) **Decrease in Depreciation.**—The auditor should ascertain the amount of depreciation written off each of the three years and enquire into the basis on which such depreciation has been calculated. If the calculation in respect of depreciation each of these years has been based on the original cost of the assets, then the amount of depreciation should be the same each of these years. If, however, the assets have been depreciated by a fixed percentage being calculated on the reducing balance of the assets, that might account for the decrease in the third year. It may be that an asset has had to be discarded and sold off at break-up value, in which case it should be seen that the difference between its book value and the amount realised on sale has been charged off to revenue.

(d) **Decrease in Interest Paid.**—The decrease in Interest paid can only be accounted for by a corresponding decrease in the amount of the loans running during the year in question. It may be that during the third year more capital may have been contributed by the proprietors to pay off the existing loans. The question of interest on loans accrued to the end of the financial period and not paid should not be lost sight of.

(e) **Increase in Sales.**—In view of the large increase in sales of the third year, those of the last month should receive very close scrutiny at the hands of the auditor to see that such sales are the outcome of actual orders received from customers and not mere fictitious entries made with a view to inflate profits. The auditor would do well to ascertain the percentage of gross profit earned on the sales each of these three years, and in case of any wide fluctuation appearing in the third year, he should thoroughly investigate into the cause of this. In this connection, an exhaustive enquiry into the method of stock-taking and the basis of valuation followed each of the years would also be found very helpful. He should with equal advantage look into the Returns Inwards Book of the immediate succeeding year to see that none of the sales have been entered back as Returns Inwards.

(f) **Decrease in Returns Inwards.**—As the figure of Returns Inwards is striking in view of the increase in the sales of the third year, the auditor should satisfy himself that no goods returned in the third year are left out from being entered in the Returns Inwards Book. In this connection, he should look into the Goods Inwards Book, if kept by the gateman, to see that all items of Returns Inwards as ascertained therefrom have been duly entered up on their respective dates.

Q. 127. *A Company having asked for tenders for construction of their Works Building, received the lowest quotation at Rs. 90,000.*

The Directors then decided to have the construction carried out departmentally by their own men, and the cost of the building as shown by the Ledger Account is made up as follows :—

	Rs.
Cost of Materials Purchased	27,000
„ of Materials Issued from Stores	13,500
„ of Direct Labour	38,000
Proportion of General Manager's Salary	3,000
Proportion of Establishment Charges	2,000
Interest on Capital Outlay involved	1,500
Amount transferred to Profit and Loss Account	5,000
	Rs. 90,000

As an auditor, would you allow this account to stand unaltered ?

A. The items that would interest the auditor would be as follows:—

- (a) Proportion of General Manager's Salary,
- (b) Proportion of Establishment Charges,
- (c) Interest on Capital Outlay, and
- (d) Amount transferred to Profit and Loss Account.

(a) and (b) Proportion of General Manager's Salary and Establishment Charges.—The auditor should ascertain how these proportions have been arrived at and whether they are legitimate and directly attributable to this work.

(c) Interest on Capital Outlay.—This item should be closely scrutinised to see if the company had to borrow any capital specifically for the purpose of such construction. If any interest has had to be paid in connection with the cost of construction, then the same can be charged to Construction Account. In any case, it is unusual to include interest in the Cost of Construction, and the auditor would be wise to invite the attention of the Shareholders to this fact.

(d) Amount transferred to Profit and Loss Account.—Under no circumstance should any profit be allowed to be calculated on the cost of construction, and transferred to the Profit and Loss Account. The auditor must positively refuse to allow such an item to be added to the cost of construction, and if the accounts are not modified, he should report the matter to the shareholders.

Q. 128. *When called upon to audit the books of a concern, you find that there is a disagreement in the books at the commencement of the period. What would be your duty in this connection ?*

A. Ordinarily, it cannot be said to be the duty of an auditor to balance the books, but he may undertake this work as an expert in consideration of an additional remuneration. As, however, the disagreement of the Trial Balance by even a small amount may arise from several grave errors of a compensating nature remaining undetected, or may be the outcome of manipulation of books to conceal defalcations, it would become his duty to try and trace the errors. An auditor cannot dismiss any disagreement in the books without sufficient enquiry into the cause of such difference.

Where the audit is that of a sole trader or a partnership firm, the auditor may protect himself by obtaining a letter from the client exonerating him from any liability in regard to the opening disagreement of books, but in case of a company audit, he must take all necessary steps to locate the errors. In any case, the auditor must investigate the books adequately to satisfy himself that the small difference is not made up of larger errors or fraudulent manipulations remaining undetected.

If by the end of the audit, the difference is not discovered, the same should not be written off but must be transferred to Suspense Account, and the fact must be clearly disclosed in the Balance Sheet. If the directors object to the existence of an error in the books being specified in the Balance Sheet, the auditor must state the fact in his report.

Q. 129. *What views would you express in regard to the Premium on the Issue of Shares or Debentures being utilised towards :—*

- (a) *Transfer to Profit and Loss Account ;*
- (b) *Transfer to Reserve Fund ; or*
- (c) *Transfer to Goodwill Account ?*

A. **Transfer to Profit & Loss Account.**—In the absence of any definite provision in the Company's Articles prohibiting such a procedure, there can be no legal objection to transferring the Premium on Shares or Debentures to Profit and Loss Account so as to make the amount available for dividend purposes. From the stand-point of sound finance and accounting, however, it cannot be said to be a desirable policy to follow as by adding gains of an extraneous and non-recurring nature, the trading profits of the year would be unduly increased and this would disturb the normal rate of dividend.

Transfer to Reserve Fund.—This would equally amount to rendering the Premium available for dividend, as a Reserve Fund can always be utilised for equalisation of dividends. The same arguments as above will therefore hold good in this case.

Transfer to Goodwill Account.—As the negotiable value of goodwill is difficult and almost impossible to determine from year to year, and as its

value is dependent on so many varied factors, it is always considered as sound and prudent to write down its book value out of profits as early as circumstances can permit. Evidently, therefore, there can be no objection to utilising the Premium on Shares or Debentures in writing down this asset of a fluctuating character.

The Premium on Issue of Debentures can best be utilised in transfer to Debentures Redemption Fund, or may be transferred to Cost of Issue of Debentures. An auditor, however, cannot object to the credit balance on Premium on Shares or Debentures being treated in any manner the directors deem fit, unless he finds that the Company's Articles are being violated.

Where any such credit extraneous to the usual course of the company's business is taken to Profit and Loss Account, the auditor should at least see that the item is clearly specified so as not to be mistaken for a business gain.

Q. 130. *The directors of a company, having ascertained an excess on revaluation of the following assets, propose to utilise it towards declaration of a bonus dividend by the issue of fully-paid shares.*

(a) Goodwill	from Rs. 50,000 to Rs. 75,000
(b) Freehold Land and Buildings	„ „ 1,25,000 „ „ 2,00,000
(c) Stock-in-Trade	„ „ 80,000 „ „ 1,20,000

Discuss the proposal.

A. As the Bonus Dividend will be distributed in the company's own shares, it is not necessary to see that the excess is realised and there remains a surplus after all the assets have been brought down to their value. It should, however, be seen that the valuation is done by independent experts of undoubted reputation.

The increase in the value of Freehold Premises may be due to the locality having found favour with the public, or the asset may have been over-depreciated in the past, and the auditor cannot object to the proposed adjustment, provided it is a fair valuation.

As to appreciation in value of Goodwill, it cannot be said to be a sound policy to bring it into record, although legally there can be no bar to this being done in the above circumstance. If this asset has been heavily written down in the past, there can be no objection to its being written up to its fair value on a subsequent occasion.

The value of Stock-in-Trade cannot be appreciated by revaluation, unless it means that in the past, the stock was considerably undervalued and it has now been thought desirable by the directors to bring it into the books at

a fair value. The auditor should, however, see that the rule of "cost or market value whichever is the lower" is strictly observed in this connection. He should most exhaustively examine the basis of valuation followed in the past and see if there really was an under-valuation.

It should be seen that the Articles authorise the payment of a dividend otherwise than in cash.

It may be pointed out that the company will not benefit by this process, as the net result of increasing the capital without receiving additional assets will be to reduce the future percentage of dividend.

Q. 131. *While examining the Profit and Loss Account of a Toy Manufacturing Company, you find that the following items have been brought into credit :—*

- (a) *Profit on Revaluation of Freehold Premises ;*
- (b) *„ on Realisation of Debtors taken over ; and*
- (c) *„ on Sale of Madras Branch Assets, and the Directors propose to distribute these in shape of a cash dividend.*

Would you certify the accounts as correct ?

A. (a) *Profit on Revaluation of Freehold Premises.*—This is a profit of a capital nature, and it cannot be distributed unless the asset is realised, the Articles do not prohibit such a distribution, and a surplus is left after a revaluation of the whole of the company's assets. There can be no objection, however, to utilising this credit balance in reducing the book value of any other fixed assets or in wiping off the debit balance, if any, on the Profit and Loss Account.

If on due inquiry, the auditor finds that the profit on revaluation of the Freehold is due to excessive depreciation having been written off in the preceding years, it is doubtful if he can raise any objection to the asset again being brought up to its present fair value. In any case, if the auditor is not satisfied with the adjustment, he should report the matter to the shareholders.

(b) *Profit on Realisation of Debtors taken over.*—Assuming that there are no restrictive provisions in the Company's Articles, a realised gain from one of the assets can be distributed after a reference to the book values of the whole of the assets.

(c) *Profit on Sale of Madras Branch Assets.*—The position here is the same as in the case of (b).

Q. 132. *The Soft Cement Co., Ltd., decided to reduce its capital with a view to a reconstruction, and its Balance Sheet on 30th June 1938, was as under :—*

BALANCE SHEET

Capital and Liabilities		Rs.	Assets		Rs.
Share Capital			Freehold Works and Buildings		15,00,000
Authorised and Issued:—			Plant and Machinery		4,50,000
50,000 8 per cent Cum. Pref.			Patents		75,000
Shares of Rs. 10 each fully			Stock-in-trade		2,50,000
paid	5,00,000		Sundry Debtors		1,20,000
25,000 Ordinary Shares of			Investments		5,00,000
Rs. 100 each fully paid ..	25,00,000		Profit and Loss Account:—		
Reserve Fund	70,000		Debit balance to	Rs.	
Bank Overdraft on Floating			30-6-37	9,95,000	
Charge on Stock	1,50,000		Less Profit 1938	2,10,000	
Sundry Creditors	4,80,000				7,85,000
			Cash at Bank	20,000	
					<u>Rs. 37,00,000</u>
		Rs. 37,00,000			Rs. 37,00,000

There was a contingent liability in respect of Cum. Pref. Dividend which was in arrears for the last two years. The Market value of Investments was Rs. 6,00,000.

On investigation, you find that the Pref. Shares are preferential also as to return of Capital. The present value of the Freehold Property is Rs. 11,50,000 and of Plant Rs. 3,00,000. The Stock is to be depreciated by 10% and a Reserve of Rs. 30,000 is necessary for Doubtful Debts. The Patents are worth Rs. 20,000 only.

You are requested to prepare your Report on a Scheme of Capital Reduction to be placed before the Board.

A. The Directors
of the Soft Cement Co., Ltd.
Gentlemen,

As desired by yourselves, we have pleasure in submitting our Report suggesting a Scheme for the Reduction of your Company's Capital to be placed before the Board's ensuing meeting.

It appears from the facts placed before us that your Company stands to have lost so far Rs. 12,25,000 resulting from working losses and depreciation in values of the assets as under:—

	Rs.
Loss on working	7,85,000
Depreciation on Building	3,50,000
Depreciation on Plant	1,50,000
Depreciation on Stock	25,000
Depreciation on Patents	55,000
Reserve for Doubtful Debts	30,000
	<u>13,95,000</u>
Less Reserve Fund	70,000
„ Gain on Investments	1,00,000
	<u>Rs. 12,25,000</u>

As the sum lost in the aggregate amounts to more than one-third of the Company's Capital, a reduction in the Company's Capital is no doubt highly desirable, and we are of opinion that the following Scheme will serve the purpose most equitably:—

As the Preference Shares are preferential also as to Return of Capital, they will not stand to lose anything in respect of capital refund, in case the Company went into liquidation. Evidently, therefore, the Preference Shareholders would not be prepared to make any capital sacrifice. If the Share Capital of the Company be reduced, the whole of the burden of capital loss will thus have necessarily to be borne by the Ordinary Shareholders.

The Ordinary Shareholders will not be averse to the nominal value of their shares being reduced to Rs. 50 each, as the Company has already lost Rs. 12,25,000 as above explained. If they are agreeable to this proposal, there would be left a sum of Rs. 12,50,000 which would enable the Company to wipe off its past losses, reduce the book values of its fixed assets to their present worth, and leave a sufficient margin for Working Capital.

In view of the prospect for immediate resumption of future dividends as would naturally result from the Capital Reduction Scheme, and in view also of the whole of the Capital loss being borne by the Ordinary Shareholders, it would seem to be fair to call upon the Cumulative Preference Shareholders to at least waive their right towards arrears of dividends. If they are agreeable to this, the Company can well convert their existing rate of dividend of 8 per cent into 9 per cent by way of compensation for the loss they agree to bear.

As the market value of the Investments happens to be far in advance of their book value, it seems desirable that they be realised and the amount thus rendered available may be utilised in paying off the Bank Overdraft and reducing the amount of other creditors by Rs. 3,00,000. This will not only relieve the Company of the burden of its immediate liabilities, but will also help to furnish it with a working capital of Rs. 1,50,000.

It would seem wrong in principle to allow the Reserve Fund to stand, as there cannot be a Reserve Fund along with a heavy debit balance on Profit and Loss Account appearing in the Balance Sheet. Evidently, therefore, this fund will have to be set off against the accumulated loss.

The above Scheme as suggested by us seems to be highly desirable in view of the Company's business having taken a favourable turn, and we have not the slightest hesitation to believe that the Cumulative Preference Shareholders as also the Ordinary Shareholders will most readily fall in with the views expressed herein. Divested thus of the heavy losses sustained in the past, with the assets brought down in value to their true intrinsic worth, supplied with ample Working Capital and favoured with an excellent market as reflected from the immediate preceding year's profit, and with more

cautious and economic working which the Board has in view, there is no reason why the shareholders may not find in this Scheme an excellent opportunity to make good their past losses.

We remain, Dear Sirs,
Yours faithfully,

Q. 133. *The following is the Balance Sheet of the Bharat Manufacturing Co., Ltd., as on 31st December 1937 :—*

✓ BALANCE SHEET

<i>Liabilities and Capital</i>	Rs.	<i>Assets</i>	Rs.
Capital, Authorised and Issued :—		Goodwill	30,000
25,000 7 per cent Cum. Pref.		Freehold Land and Building ..	1,30,000
Shares of Rs. 10 each fully		Plant and Machinery ..	1,05,000
paid	2,50,000	Patents	75,000
25,000 Ordinary Shares of		Stock-in-trade	1,10,000
Rs. 10 each fully paid ..	2,50,000	Sundry Debtors	1,40,000
6 per cent Debentures giving a		Cash at Bank	2,500
Floating Charge on the Assets	1,50,000	Profit and Loss Account	1,65,000
Interest on Debentures unpaid ..	18,000	Less Profit	45,000
Bank Overdraft	30,000		<u>1,20,000</u>
Sundry Creditors	14,500		
	<u>Rs. 7,12,500</u>		<u>Rs. 7,12,500</u>

The Preference Dividends are three years in arrears.

The working of the Company for the year 1937 having shown considerable improvement yielding a net profit of Rs. 45,000 which profit is likely to be maintained even in the near future, the Directors decide upon a scheme of reconstruction with a reduction of Capital so that regular payment of dividends may be maintained in the future.

With a view to assist in the scheme, the Debenture-holders have agreed to accept Ordinary Shares for half the amount of the Interest due to them and forego the balance and to accept further Debentures for Rs. 60,000 for cash giving a floating charge to help towards repayment of Bank Overdraft and to provide Working Capital.

While the Preference Shares do not give any Preference as to refund of Capital, any arrears of dividend has a first charge on any surplus in case of winding up. The Preference Shareholders are agreeable to forego half the amount of their accumulated dividend, to accept Ordinary Shares for the remaining half and to reduce the future rate of dividend to 6%.

Draft a suitable scheme as would help the Company to reorganise on the following lines :—

- (a) *To write off Goodwill ;*
- (b) *To write off accumulated Loss ;*
- (c) *To depreciate Plant and Machinery by 10% ;*
- (d) *To write down Patents by Rs. 45,000 ;*
- (e) *To provide 5% for Doubtful Debts ; and*
- (f) *To depreciate Stock by 10%.*

A. DRAFT SCHEME FOR REDUCTION OF CAPITAL.

(1) The total amount required to adjust matters under the Scheme of Reduction is as under:—

	Rs.
For writing off debit balance on P. & L. A/c. ...	1,20,000
For writing off Goodwill	30,000
In reducing values of assets:—	Rs.
Patents	45,000
Plant	10,500
Stock-in-trade	11,000
	66,500
In providing for Doubtful Debts	7,000
In providing for half arrears of Cumulative Dividend	26,250
	Rs. 2,49,750

(2) As the Preference Shares do not carry any preferential right as to refund of Capital, the loss of capital that would arise in case the Company went into liquidation will have to be borne equally between the Preference and the Ordinary Shareholders. The facts, however, that the Preference Shareholders have agreed to a reduction in the future rate of dividend which in itself would adversely affect the value of their shares, and that they have agreed also to forego their claim to half the extent of the arrears of Cumulative Dividend, must necessarily be brought into account while considering the reduction in the nominal value of their shares. In order, therefore, to equitably adjust the rights of the Preference and the Ordinary Shareholders *inter se*, it is suggested that the Capital Reduction may be brought about in the following manner, and the Share Capital be reorganised as under:—

(c) The Debenture-holders be allotted 2,250 Ordinary Shares of Rs. 4 each fully paid in full satisfaction of half the arrears of their Interest, the Company's liability in respect of the other half being cancelled, thus representing a reduction of 9,000

(6) As a result of the above adjustments, the Company's Balance Sheet on a reorganization of its Share Capital will assume the following shape:—

Capital and Liabilities		Rs.	Rs.	Assets		Rs.	Rs.
25,000	Pref. Shares of			Freehold Property			1,30,000
Rs. 5 each	..		1,25,000	Plant and Machinery	1,05,000		
25,000	Ord. Shares of			Less written off	10,500		
Rs. 4 each	..	1,00,000					94,500
2,250	Ord. Shares to			Patents ..	75,000		
Debenture-holders	..	9,000		Less written off	45,000		
6,562½	Ord. Shares to						30,000
Pref. Shareholders	..	26,250		Stock-in-trade	1,50,000		
			1,35,250	Less written off	11,000		
Debentures, giving a floating							99,000
charge	2,10,000		Sundry Debtors ..	1,40,000		
Sundry Creditors	14,500		Less Reserve for D/D	7,000		
Contingency Reserve	..	34,250					1,33,000
				Cash at Bank		32,500
		Rs. 5,19,000				Rs. 5,19,000	

(7) The Company's Share Capital having been reorganized as shown above, and assuming that the Profit of Rs. 45,000 as made in the preceding year will be consistently maintained in the future, the following allocations could then be easily made thereout:—

	Rs.	a.
In paying Debenture Interest ...	12,600	0
In paying 6% Dividend to Pref. Shareholders	7,500	0
In paying 9% Dividend to Ord. Shareholders	12,172	8
	Rs. 32,272	8

leaving a balance of Rs. 12,727-8-0 to be carried to Reserve so as to help towards additional Working Capital as also to enable the Company to meet any future contingencies that might arise.

Q. 134. *The Directors of the Indian Wares, Ltd. find themselves in a very awkward situation, and consult you in regard to the ways and means of reorganizing the financial position of the Company. The P. and L. A/c. for the year ended 31st December 1937, showed a clear net profit of Rs. 45,000 but the equivalent Cash for the payment of Dividend was not available. They find a temporary loan from the bankers to be necessary for this purpose and are anxious to know how the profits have been merged in the business.*

You are presented the following two Balance Sheets for the purpose of placing before them the whole position clearly in the shape of a Report :—

BALANCE SHEET

As at 31st December 1936

Liabilities and Capital	Rs.	Assets	Rs.	Rs.
Share Capital: Authorised, Issued and Paid up	3,00,000	Freehold Land and Buildings ..	1,50,000	
Redeemable Debentures	50,000	less Depreciation ..	3,000	
Sundry Creditors	60,000			1,47,000
Reserve Fund	50,000	Plant and Machinery ..	1,70,000	
Profit & Loss Appropriation A/c. 40,000		less Depreciation ..	17,000	
				1,53,000
		Work-in-Progress ..	60,000	
		Stock of Materials ..	35,000	
		Sundry Debtors ..	75,000	
		Cash at Bank ..	30,000	
				Rs. 5,00,000
	Rs. 5,00,000			

BALANCE SHEET

As at 31st December 1937

<i>Liabilities and Capital</i>		<i>Assets</i>		
	Rs.		Rs.	Rs.
Share Capital: Authorised, Issued and Paid up ..	3,00,000	Freehold Buildings	1,47,000	
Redeemable Debentures ..	000	less Depreciation	2,940	
Sundry Creditors ..				1,44,060
Reserve Fund ..	50,000	Plant and Machinery	1,53,000	
Bank Overdraft ..	3,060	Additions	67,000	
Profit and Loss Appropriation A/c.—				
Balance on 1st Jan. 1937 ..	40,000		2,20,000	
less Dividend ..	36,000	less Depreciation	22,000	
	4,000			1,98,000
Net Profit during the year	45,000	Work-in-Progress	..	55,000
	49,000	Stock of Materials	..	45,000
		Sundry Debtors	..	95,000
	Rs. 5,37,060			Rs. 5,37,060

The additions to Plant and Machinery are made up of Rs. 15,000 ordinary replacements and the balance represents actual additions to Plant. The Freehold Land and Buildings cost originally Rs. 2,00,000 when acquired ten years back.

A. The Board of Directors,
The Indian Wares, Ltd.,
Bombay.

Dear Sirs,

As desired by yourselves, we have thoroughly scrutinised the financial position of your Company as reflected by the Balance Sheets dated the 31st December, 1936 and 1937 respectively, more particularly with the object of ascertaining how the profits have got merged in the business and as to how best the financial reorganization of the Company may be brought about.

To begin with, it is apparent that the acquisition of additional Plant amounting to Rs. 45,000 and the repayment of Debentures to the extent of Rs. 5,000 during the year under review are mainly responsible for the insufficiency of Working Capital and want of liquid assets.

There has been net increase in your Company's Fixed Assets as under:—

	Rs.
Increase in Plant (after deduction of Depreciation) ...	45,000
Repayment of Debentures to the extent of ...	5,000
	50,000
Less Depreciation of Building ...	2,940
Net Increase in Fixed Assets	Rs. 47,060

As to the Company's position in regard to its liquid resources, the following facts reveal a reduction in value of your net floating assets to the extent of Rs. 38,060.

	Rs.
Increase in Trade Liabilities	30,000
Decrease of Cash and Bank Balances	33,060 *
Decrease in value of Work-in-progress	5,000
	<u>68,060</u>
Less Addition in Debtors	20,000
Addition in Stock	10,000
	<u>30,000</u>
Decrease in Net Floating Assets	Rs. 38,060

The addition of Fixed Assets of the value of Rs. 47,060 is thus explained by the corresponding reduction in the Net Floating Assets of the value of Rs. 38,060 and the absorption of the credit balance of Rs. 9,000 left on the P. and L. A/c. after payment of Dividend for the year 1936.

The difficulty of finding cash for the payment of dividend despite the fact that the Company has made profits has thus evidently arisen from the Company's cash resources having been utilised in the acquisition of additional Fixed Assets, instead of being employed as Working Capital. This is, no doubt, a wrong financial policy to follow, and a continuity of the same will surely land the Company into serious financial embarrassment, in spite of improved working results. There should be a regular supply of ample Working Capital to enable the Company to finance its current operations smoothly, and the Company must find further Share Capital or secure a loan for a lengthened period, to enable it to acquire additional fixed assets as the exigency of trade might necessitate.

In view of the continuous expansion of your Company's business and with the net profits steadily on the up-grade, we are inclined to believe that an offer of New Share Capital of Rs. 1,50,000 with a premium of 10 per cent to the existing shareholders would meet with a ready response from them. Whereas the shareholders would find in these shares a safe and lucrative investment, the Company would stand to benefit from the premium received. Such a step would also at once help the Company to pay off its Bank Overdraft, meet its pressing liabilities and leave a sufficient margin by way of Working Capital.

An alternative method would be to issue Debentures of a like amount, but this will entail an interest burden and would necessitate mortgaging or charging of some of the Company's assets. Considering all the facts, therefore, we are of opinion that it will be in the best interests of the shareholders to take up additional capital as suggested above so that they may benefit from the whole of the Company's profits in the future, subject of course to

an adequate Reserve Fund being maintained, so as to provide against any future contingency.

We remain, Dear Sirs,
Yours faithfully,

Q. 135. *The Board of Directors of a company desirous of approaching bankers for a Loan; seek to know from you as to the lines on which the bank would ask for information. Draft a report on the same.*

A. The Board of Directors,
The Blaff Co., Ltd.,
Bombay.

Gentlemen,

In response to your enquiry as to the information in regard to a Company's position which any bank would seek to obtain, and the main factors the bankers would consider for the purposes of granting a loan, we have pleasure in submitting our Report as under:—

(1) In the first place, they would like to be informed as to whether the loan asked for is for redeeming any existing loan that has become due or for being employed as additional working capital. If the latter is the purpose, the bankers will have to be satisfied that the business is capable of profitable expansion, and if the former, the bank would seek to know if the existing assets would form sufficient and easily realisable security for the proposed loan, after all prior claims have been satisfied.

(2) The company's Memorandum and Articles would be consulted with a view to find out whether there are any restrictions on the borrowing powers of the company, and whether the loan asked for is well within the limits, if any, imposed thereby.

(3) A complete list of the Fixed Assets would have to be prepared together with full particulars indicating the original cost and the extent of depreciation provided for so far in respect of each of these.

(4) If any of the company's assets are mortgaged or pledged, full particulars thereof would have to be stated.

(5) All intangible, fictitious or unrealisable assets will have to be ignored as these will hardly have any realisable value.

(6) The list of Sundry Debtors will call for an exhaustive scrutiny. The usual period of credit allowed to customers having been ascertained, it will be seen what debts, if any, are overdue. A complete list of doubtful debts as also the usual cash discount will have to be submitted in order to enable a fair estimate to be made of the present total realisable value of the book debts.

(7) The basis of valuation of Stock-in-trade and Work-in-progress will call for a searching scrutiny to ascertain that there is no over-valuation, and

that goods received on consignment or items of obsolete or unsaleable stock are not included in the list.

(8) A further enquiry would be made to ascertain if any portion of stock is pledged as security or is subject to any floating charge.

(9) If there happen to be any investments, a full list of these will have to be produced distinguishing between the cost and the present market value of each of these. It will be further shown if any of these are subject to any charge.

(10) The Liabilities of the business will have to be distinguished between *fixed* and *floating*. It will further be shown whether any of these are overdue, and to what extent any liabilities are secured, indicating the nature of securities pledged.

(11) How far the existing Debentures, if any, stand in respect of their security will have to be clearly indicated.

(12) The average working capital (i.e., the excess of floating assets over the floating liabilities) employed in the business would be scrutinised to ascertain if the same adequately meets with the requirements of the business.

(13) Enquiry will be made as to whether the sales and profits of the business are on the up-grade or down-grade, whether the business is capable of bearing the additional burden of loan interest and whether the net profits represent a remunerative return on the capital employed.

(14) A statement will have to be made detailing Contingent Liabilities, if there be any.

The whole of the information stated above may be embodied in the shape of a Balance Sheet supported by supplementary statements giving fullest particulars, so that the exact financial condition of the business may be duly reflected.

We remain, Dear Sirs,
Yours faithfully,

Q. 136. *Discuss briefly the liabilities of an Auditor to a Public Company and mention some Legal Decisions you know of in this connection.*

A. The following are the general heads under which an auditor may be held liable in damages to his clients:—

(1) He is liable under the Common Law to make good any damage sustained by his client by reason of fraud or errors which he should have discovered if he had exercised reasonable care and skill in carrying out his duties. Such a liability may arise where he has been negligent in examining the books of account, or in verifying the existence and value of the assets, or in omitting to bring in the whole of the liabilities in the Balance Sheet, so that the latter fails to reflect the true position of the company in question.

(2) Section 235 of the Indian Companies Act further extends this liability whereby an auditor is liable for misfeasance or breach of trust as an officer of a company, where a company is in the process of being wound up and it appears that it has suffered loss due to failure on the part of the auditor in the due performance of his duties.

(3) He may also be held liable under Section 282 of the Indian Companies Act, to a fine or imprisonment or both, if he wilfully makes a false statement in any return, report, certificate, balance sheet or any other document required under the Act.

There have been several cases before the Courts regarding the duties and liabilities of auditors of which the following may be cited:—

(1) In *re London and General Bank Case*, it was held that an auditor is guilty of misfeasance who, when dissatisfied with the accounts of a company, does not plainly draw attention to the grounds for his dissatisfaction in his report to the shareholders. There was an over-valuation of assets which resulted in dividends being paid out of capital. The auditor had reported to the Directors who refused to alter the accounts. In his report to the shareholders, however, he merely stated that "The value of the assets as shown in the Balance Sheet is dependent upon realisation."

(2) In *re the Kingston Cotton Mill Company Case* it was held that in the absence of suspicious circumstances, the auditor is not guilty of negligence, if he relies upon the representations made by the trusted officers of the company and provided he exercises reasonable care and skill. There had been systematic over-valuation of stocks on hand, and as a result, dividends had been paid out of capital. The auditor relied upon the summary of the stocks as certified by the manager, and had made a note against the item of Stock in the Balance Sheet, "As per the manager's certificate".

(3) In *Leeds Estate Building and Investment Company vs. Shepherd*, it was discovered that the Balance Sheets had presented a false and misleading state of affairs, and the auditor was held liable to make good the several sums paid out of capital for dividends and for fees and bonuses which became payable to the directors and the manager upon declaration of dividend. The auditor was not furnished with a copy of the Articles, and did not therefore comply with their provisions. It was no excuse for the auditor that he had not seen the company's Articles when he knew of their existence.

(4) In *The Irish Woollen Company, Limited vs. Tyson and others*, there was considerable under-statement of trade liabilities by some of the purchase invoices being systematically suppressed and entered in the following period, and the auditor was found in a material respect to have failed in the discharge of his duties. It was held that this could have been discovered if the auditor had called for the Creditors' Statements and checked the same with the relative Ledger Accounts.

(5) In *The London Oil Storage Company Case*, the Company had sustained loss by reason of negligence on the part of the auditor to verify the

existence of the petty cash in hand, and it was found that there was not a sufficient fulfilment of the auditor's duty to ascertain whether the asset really existed. The auditor was held liable in damages.

(6) In *Arthur E. Green and Company vs. The Central Advance and Discount Corporation*, was held that, in certain circumstances, an auditor may be held negligent in accepting schedules of bad debts supplied to him by the Managing Director. The Auditors having made inquiries had received no satisfactory explanations, and they failed to report the matter to the shareholders.

Q. 137. *Discuss the legal position of the auditor in regard to the Depreciation on the Fixed Assets of a Limited Company, citing some cases in this connection.*

A. Ordinarily, the auditor to a Limited Company is assumed to inquire into the adequacy of the provision for Depreciation on the company's Fixed Assets before arriving at the net profits. As to what provision should be made would be decided upon by the Directors and officials of the company, with due regard to the company's Articles. If the auditor is not satisfied in this regard, he should place his views before the Board, and if the Directors still refuse to amend the accounts as suggested by him, he should refer to the matter in his report to the members.

There have been several decisions on the question of Depreciation prior to ascertainment of divisible profits, but these are conflicting in character, and there is no general rule of law as may be applied equally to all cases and in all circumstances. The net result, however, of the decisions seems to be that a company is under no legal obligation to make good depreciation on its fixed assets, provided there is nothing in its Articles requiring it to do, and that it retains sufficient assets to discharge its liabilities. This, however, will in no way affect the duty of the auditor to the shareholders.

The principal decisions on the question of Depreciation may be summarised as under:—

In *Lee vs. Neuchatel Asphalte Company, Limited*, it was held that a company formed to acquire and work a wasting asset, such as a mine, need not make good any depreciation on such asset before ascertaining distributable profits.

In *Bolton vs. Natal Land and Colonisation Company, Limited*, it was held that a company may declare a dividend out of current profits without necessarily making good loss of capital assets. In one particular year, the company wrote off a bad debt of £70,000, and to cover this amount, the book value of its Lands was written up to a like amount. Because of this step, it was not necessary in each subsequent year to adjust the value of such lands, even in view of its having been written up in a previous year.

In *Verner vs. The General and Commercial Investment Trust, Limited*, it was decided that the Investments were Fixed Assets of an Investment Trust

Company, and subject to its Articles, it was not necessary to make good any depreciation in their capital value prior to distribution of current excess of income over current expenditure. It was said that "fixed capital may be sunk and lost, and yet the excess of current receipts over current payments may be divided, but floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess".

In *Wilmer vs. McNamara and Company, Limited*, it was decided that a transport company may declare a dividend out of current profits without providing for depreciation of its Fixed Assets, which consisted of Goodwill, Leasehold, Vans, Plant, etc.

In *Bond vs. The Barrow Haematite Steel Company, Limited*, the Directors made a provision, out of revenue, for the loss arising from the surrender of leases due to adverse circumstances, and this prevented the payment of a dividend. It was held that Preference Shareholders cannot claim to be paid dividends out of current profits as a matter of right and without regard to such provision for reserves as the Directors may deem fit to make as authorised under the Articles.

Crabtree vs. Crabtree. In this case, the trustees under a will were authorised to carry on the business during the lifetime of the tenant for life, who was to be paid the net profits. In arriving at such profits, certain depreciation was written off machinery over and above the repairs, which was objected to by the tenant for life. It was decided that the depreciation was properly charged.

Q. 138. *Can a company divide its current profits without making good past losses? Discuss any decided case on the subject.*

A. Where a company has made losses in the past and then makes a profit out of which a dividend is paid, such a dividend cannot obviously be said to have been paid out of capital. As a matter of fact, the assets representing the paid-up capital would remain at just the same value as before the payment of dividend. From the view-point of sound finance, however, a more desirable method would be to extinguish past losses by setting off current gains against these, but if the latter are not so utilised and instead applied in paying a dividend, such a payment would not involve a reduction of capital or what there is left of it. Such a step would only result in a failure to make good capital that had already been lost.

The legal position as to the divisibility of current profits without making good past losses, was discussed in the *Ammonia Soda Company, Limited vs. Chamberlain*. The company had written up the value of certain lands as a result of its re-valuation by the directors, and utilised the appreciation in value in writing off the previous debit balance on Profit and Loss Account, in order to render current profits available for payment of dividends. It was held that a company may write up the value of its assets as a result of a *bona fide* valuation and may distribute current profits without first making

good past losses. The directors had concealed nothing from the shareholders, and the auditor's report to the shareholders had fully disclosed the above transactions.

Q. 139. *Can a company write up its assets which had previously been written down excessively out of profits and apply the amount in payment of dividends? Is there any legal decision on the point?*

A. In *Stapley vs. Read Brothers, Limited*, the item Goodwill had been written down out of profits to a figure considerably below its real value. In a subsequent year, the excess was credited back to the Profit and Loss Account and was distributed as a dividend. In this case, it was decided that as the amount by which the asset is written up was in the nature of an adjustment of profits previously written off in excess of true requirements, and as the readjusted value of Goodwill did not exceed its then true value, there was nothing to preclude the company from treating such appropriated profit written back as available for distribution, provided the company's memorandum or the articles did not prohibit such a procedure. In other words, excess depreciation written off in the past may be transferred back to Profit and Loss Account in any subsequent year, provided the value of the asset thus readjusted is not shown beyond its then real value to the business. Such a case stood on quite a different footing from the case of capital appreciation which is not available for distribution until the asset is realised and the values of all the other assets are received and a surplus is shown.

Q. 140. *What are Capital Profits? Discuss the legal as well as the commercial view-points regarding the distribution of these as dividends.*

A. Capital Profits are such as do not arise from transactions appertaining to the trade, but result from other sources. Amongst capital profits may be included: (a) Premium received on issue of shares or debentures, (b) Any amount standing to the credit on re-issue of Forfeited Shares, (c) Profit realised on sale of a Fixed Asset, (d) Profit earned by a company prior to Incorporation or Commencement Certificate, (e) Profit realised on redeeming company's own Debentures by purchase in the market at a discount.

As to items (a), (b) and (c), there is no legal objection to distributing such profits as dividends provided the company's Articles do not prohibit such a distribution, and provided the real nature of such credit to Profit and Loss Account is clearly disclosed. From the view-point of sound commercial policy, however, it would seem to be prudent to conserve such extraneous gains to help as additional working capital or towards extension of business, or to meet any capital loss, or to enable the company to meet some unforeseen contingency that might arise in the future. Such capital gains may also be advantageously utilised in reducing or wiping off intangible assets like Preliminary Expenses, Brokerage on Shares, Underwriting Commission, Discount on Issue of Debentures, etc.

As regards (d), legally it cannot be said that a company earned revenue profits prior to the date of its incorporation or commencement certificate, and such profits cannot, therefore, be distributed as dividends.

As to (e), it was held in *Wall vs. London and General Provincial Trust Company, Limited*, that having regard to its Articles, the company cannot treat profits made on the redemption of its Debentures as being available for dividend. The view taken by the Court was that the company could not regard such a profit in the nature of a revenue profit as it resulted from the extinction of its own liability.

In *Lubbock vs. The British Bank of South America*, and *Foster vs. The New Trinidad Lake Asphalt Company, Limited*, it was held that a profit on the sale of part of an undertaking can only be distributed as dividend provided—

(a) The profit is actually realised;

(b) That a surplus remains after the whole of the other assets have been re-valued; and

(c) That the company's Articles do not forbid the distribution of capital profits.

Q. 141. *What system of Internal Check and Control over Stores of a large manufacturing concern would you suggest, if called upon to do so?*

A. (1) Proper Stores Accounts should be maintained recording in detail quantities purchased and issued, so as to facilitate comparison of the quantities actually in hand at any time with those as indicated by the Stores Records.

(2) Such Records should be kept by persons other than those who actually handle the stores, so as to serve as a check on them.

(3) Independent stock-taking by actual count must be carried out continuously by persons other than the Store-keepers or the Stores Record Office, so that any discrepancies may be soon detected and set right.

(4) Each item of stores must be kept in a separate bin or other receptacle, and the entire store-room should be systematically arranged so as to facilitate issues.

(5) Maximum and minimum stock quantities of each item of stores should be fixed by the management, and it would be the duty of the store-keeper to enter these on the respective Bin Cards and inform the Buying Department as soon as any item goes below the required minimum, so that the same may be replenished.

(6) Only the store-keeper and his subordinates should have access to the stores, and no one else should be allowed to enter the store rooms except those in possession of Stores Issue Requisitions.

(7) No stores or materials should be issued except on presentation of Stores Issue Requisitions duly signed by the foreman of the department re-

quisitioning the goods, or some other responsible official. On no account should any item be issued upon verbal request.

(8) The record in the Store Rooms should consist only of Bin Cards, attached to each Bin or receptacle, which should be written up by the store-keeper on receipt or issue of each item of stores. Such a record will show quantities received, issued and the balance quantities from time to time.

(9) On receipt of Stores or Materials from time to time, these should be checked, and Stores Received Notes should be made out by the store-keeper in duplicate showing the quantities of the different types of stores received. One copy of this will have to be sent to the Buying Department and the other will form the Store-keeper's record from which the Bin Cards would be entered up.

(10) On each Stores Issue Requisition being presented to the store-keeper in duplicate, the latter will tick off the items issued and return one copy to the party presenting the same. The latter will then be made to sign the other copy as an acknowledgment of the receipt of stores by him, and this copy will be retained by the store-keeper, from which he would enter up the quantities issued on the relative Bin Cards.

(11) The quantities as shown on the Stores Received Notes sent by the Store-keeper to the Buying Department will be checked by the latter with their relative Invoices. The Buying Department after filling in the cost price against each item, will then send the same to the Stores Record Office, and from these, the Quantities Received will be entered in the Stores Cards together with their respective values.

(12) The Stores Issue Requisitions, after being entered up on the Bin Cards will be sent by the Store-keeper to the Stores Record Office which would be located apart from the Store Rooms. From these, the issues will be entered up independently in the Stores Cards which would contain record of quantities as also values.

(13) Thus, whereas the record of Stores Cards would consist of Quantities Received and Issued with their corresponding values, the Bin Cards will record quantities only.

(14) The Stores Record Office will form a section of the Costing System, and for this purpose, it will have to analyse the stores issued to the several Jobs, Order Numbers, Contracts or Departments, as the case may be, showing the quantities and values of such issues.

(15) From day-to-day, it would be the duty of the Inspection Department attached to the Costing Section to verify some items of stores by actual count and check the same with the balance quantities as shown by the relative Bin Cards and Stores Cards. No previous intimation should be given to the Store-keeper as to which items are to be checked on any particular day. On any discrepancies being detected, the same would immediately be inquired into, and a close check would thus be maintained on the Store-keeper, who would be held responsible for the quantities in his charge.

(16) Materials or stores, if any returned from a Job or Department, should be accompanied by Stores Returned Notes in duplicates, which should be dealt with in just the same manner as the Stores Requisition Notes, and entered in the Bin Cards as well as Stores Record Cards.

The above rules, if rigidly followed, will serve as a great check on the incomings and outgoings of stores, and will at once bring to light any wastage or pilferings.

Q. 142. *Suggest a set of rules you would recommend for the Internal Control over the Purchases of Raw Materials and Stores of a large manufacturing business.*

A. For securing a proper control over Purchases, the following rules may be suggested:—

(1) Every Purchase should originate from a written Purchase Order issued under the authority of the head of the Buying Department.

(2) All the Departments of the business should state their requirements on Purchase Requisitions to be sent to the Buying Department which would look to the necessary buying.

(3) All Purchase Orders should be made out in triplicate—one copy to remain with the Buying Department, another to be sent to the suppliers, and the third one to the stores receiving clerk.

(4) On receipt of goods, the Stores Receiving Department will write out the particulars on the Goods Received Notes in duplicate, after actual inspection, count or weighing of the goods.

(5) One copy of each Goods Received Note would be sent to the Buying Department which would compare the quantities and qualities as mentioned therein with their relative Invoices.

(6) Each Invoice on receipt should be checked with its corresponding Purchase Order to see that the quantities sent are as per order and that the prices charged are legitimate.

(7) Where necessary, all goods on arrival should be inspected and tested as to quality before being stored.

(8) Each Goods Received Note should be signed by the Store-keeper as also the Inspector before being sent to the Buying Department as an indication of goods having been duly received and inspected on arrival.

(9) Any defects in goods should be reported immediately on receipt, so that the Buying Department may take up the matter.

(10) The prices and extensions of each Invoice having been checked by persons responsible for the same, the Invoices will be entered in the Purchase Journal.

(11) Each Invoice should be consecutively numbered and then properly filed. It should also be rubber-stamped to indicate the checking in respect of prices, and calculations having been done.

(12) The Goods Received Notes after being checked with the Invoices, and the values being filled in will be sent to the Stores Record Department which would be independent of the Store-keeper.

(13) No payment should be made to any supplier until the Statement received from him is checked with the corresponding Ledger Account and is duly authenticated as to its correctness.

(14) All Returns Outwards should be duly authenticated and the corresponding Debit Notes should be signed by some one in authority.

(15) The Purchase Orders, the Goods Received Notes and the Invoices should all bear references to each other.

Q. 143. *What steps would you suggest for proper Internal Check over Credit Sales?*

A. The essential points in any system of internal check on Credit Sales may briefly be summarised as under:—

(1) All Orders from customers should be obtained in writing.

(2) Each such order should then be checked with its corresponding goods before dispatch.

(3) Upon execution of the order, a Sales Invoice should be prepared in triplicate.

(4) The prices charged and the extensions should be checked by those responsible who will affix their initials indicating the nature of checking done.

(5) One copy of the Sales Invoice will then be sent to the customer. The other copy will also be sent to the customer which on being signed and returned by him will serve as an acknowledgment of delivery.

(6) Each such Invoice should be consecutively numbered and duly initialled by some one in authority before dispatch.

(7) The third copy of the Sales Invoice will form the basis of the Sales Journal from which the accounts of the customers concerned will be debited.

(8) All cases or packages leaving the premises should be entered in Goods Outwards Book, and no goods should be allowed to leave the premises except under proper authority. The Goods Outwards Book should indicate the number of the Sales Invoice against each entry.

(9) A proper control should also be maintained on Returns Inwards by each such Return being entered in a Goods Inwards Book kept by the gate-keeper.

(10) Such records of Returns Inwards by the gate-keeper should be checked with the Debit Notes sent by the customers.

(11) The receipt of goods returned will be checked with the Advice Note or Debit Note sent by the customer, which will be initialled by the person who has done such checking.

(12) All such Advice Notes or Debit Notes will be numbered consecutively and filed, and their corresponding Credit Notes having been made out by the counting-house in duplicate and initialled by some authorised person, one copy will be sent out to the customer.

(13) Entries must be made from the Credit Notes in the Returns Inwards Book from which the customers' accounts concerned will be credited.

(14) No unusual discount or allowance should be given to any customer without due authority.

(15) There should be a strict control on collection of customers' accounts, and periodical statements should be sent to them with a request to inform the management immediately in case of any discrepancy as to the balance owing.

Q. 144. *Discuss fully the question of issue of Bonus Shares from the Reserve Fund, and the auditor's duty in this respect.*

A. Where the Directors find that the Reserve Fund created out of undistributed profits has reached a stage beyond its legitimate purpose, it is usual to declare a Bonus to the shareholders from the Reserve Fund, and thus capitalise the Reserves. The company's Articles must be consulted to ascertain that they do not forbid such a distribution.

The auditor should inspect the minutes recording the resolutions of the Board and the shareholders, and see that all other legal requirements have been duly fulfilled.

The accumulation of reserves always tends to add to the working capital of the company with consequent increase in the earning capacity of the business. This would result in dividends being declared at unusually high rates, and the company's employees and customers would seem to feel that they have not been fairly dealt with. Besides, substantial dividends from year to year would attract investors, and may tend to create competition by similar businesses being set up.

By a permanent capitalization of Reserves, the share capital of the company is thus brought into truer relationship with the capital actually employed for the purpose of earning profits, and although the percentage of the dividend would naturally dwindle due to the increased capital, the total distribution to the shareholders would not be affected.

By the undistributed profits being permanently retained in the business as additional capital, the company can extend its operations by applying the proceeds of the new issue in acquiring revenue-producing assets.

Whereas the liquid position of the company is not weakened by this new issue, the shareholders receive the profits so far held over in a form which can easily be turned into cash by sale of the new shares in the market, if they so wish it.

If the company is not able to maintain the same rate of dividend in the future, the market price of the shares may suffer. If the directors, however,

try to keep up the same high rate of dividend by utilising its remaining reserves, the security behind the shares will disappear, and this may adversely affect their value.

The issue of Bonus Shares may create a speculative demand for the shares in the market, and the shares may not maintain a stable value as a result of violent fluctuations due to speculative dealings.

Q. 145. *When consulted by the Directors as to whether it would be desirable to pay an Interim Dividend, on what points would you direct your inquiries, before giving an opinion?*

A. Before expressing an opinion in regard to the payment of an Interim Dividend, the following points will have to be inquired into:—

(1) The amount of net profits made to date, and how it compares with the corresponding period of the preceding year.

(2) The net profit earned to date would have to be substantiated by the preparation of an interim Profit and Loss Account.

(3) What prospects there are of earning profits for the remaining period of the financial year, and how they compare with the profits already made.

(4) If the business is a seasonal one, whether the profits already made include the profit of the seasonal period.

(5) What volume of business is likely to be secured in the period to follow, and its comparative position in relation to the same period of the preceding year.

(6) Whether there are any prospects of adverse fluctuations in the price of materials or wages in the immediate future as would reduce the normal anticipated profits of the succeeding period.

(7) Whether the liquid position of the company would in any way be seriously affected by the distribution of dividend.

(8) Whether any capital expenditure is intended, or whether cash would be required in the near future under any contracts, or for repayment of loans, or for payment of bills maturing, as would necessitate conserving of liquid resources.

(9) Whether full provision has been made for all likely losses or contingencies that may arise in the immediate following period.

(10) Whether there is the slightest chance of a heavy loss arising on any existing contract as would wipe off the profit already made and would upset all sanguine calculations.

(**NI**) The profits available having thus been ascertained, and provided the result of the inquiries is favourable, there can be no objection to an Interim Dividend being declared, if there are sure prospects of a final dividend being payable on completion of the financial period. In view of the fact, however, that the final dividend must be of a larger amount, the Interim Dividend should be declared on a very conservative basis, and only a small

portion of the profit made should be distributed. This precaution is highly necessary in view of the fact that should the profits of the completed financial year prove to be less than the Interim Dividend paid, the Directors may be held personally liable for the payment of dividend out of capital, unless there was any previous balance of undistributed profits to justify such dividend.

Q. 146. *Mention the several ways in which Goodwill Account would find its place in the books of a company, and state what steps an auditor should take to satisfy himself as to its correctness.*

A. (1) Where a company has acquired an established business and paid for its Goodwill, the auditor should examine on the first succeeding audit the purchase agreement to ascertain if the amount in respect of this item has been brought in at a correct figure. It will then be left to the Board to decide from year to year if any provision should be made from the profits in respect of fall in value of this asset which is of a most fluctuating character. He should see, however, that the Goodwill is not written up above cost at any subsequent date.

(2) If Goodwill has resulted from any Development Expense or Exceptional Advertising having been capitalised, as in the case of Newspaper Concerns, the payments should be vouched with their relative receipts, and the auditor should satisfy himself that no expenditure has been capitalised which should have been more correctly charged off to revenue. The further duty of the auditor, in such a case, would be to see that the fact that Goodwill has been created by the capitalization of Development Charges or Exceptional Advertising should be clearly stated on the Balance Sheet underneath this item.

(3) If the debit to Goodwill Account arises from a Loss prior to Date of Incorporation or Commencement Certificate having been charged thereto, the auditor should carefully verify the apportionment of such loss between the periods before and after the date of Incorporation or the Commencement of Business to ascertain that the Goodwill Account stands charged with the correct amount. He should also see that the fact that the debit to Goodwill arises from the Loss prior to Incorporation having been charged thereto is either clearly disclosed on the face of the Balance Sheet or is mentioned in his Report to the Shareholders.

(4) Where Goodwill which had previously existed but had been written off out of profits is again brought into the books, the auditor should examine the Board's Resolution giving effect to such an entry, and should make sure that the item does not appear in the books at anything more than its present value. He should most carefully ascertain the basis of such re-valuation and see that the Profit and Loss Account is in no case credited with more than the sum previously written off. It would equally be his duty to see that the corresponding credit on the Profit and Loss Account fully discloses the nature of such entry. (*Stapley vs. Read Brothers, Limited.*)

(5) Where Goodwill had not previously existed in the books of the company, but has been brought in as a result of a re-valuation of the company's assets, the auditor should ascertain that such valuation is *bona fide*. There can be no objection to passing such an item provided he takes care to see that the fact is clearly indicated on the Balance Sheet, and that the corresponding credit is not utilised in distribution as dividend, but is set off against any debit balance on Profit and Loss Account or is utilised in writing down any other asset which appears to have been over-stated. (*Ammonia Soda Company vs. Chamberlain.*)

Q. 147. *Is it the duty of an auditor to see that the Balance Sheet signed by him is placed before the Shareholders at the Annual General Meeting?*

A. The auditor is in no way responsible for the publication and sending of the company's Balance Sheet and his Report thereon to the members. It was held in the *Allen, Craig and Company, Limited, Case* that the duty of the auditor was discharged when he affixed his signature to the Report attached to the Balance Sheet and forwarded it to the Secretary of the company, leaving him or the Directors to perform such duties as are imposed by the statute in regard to the publication of the auditor's Report to the shareholders. If the Directors did not convene any general meeting, it was for the shareholders to insist upon the requirements of the statute being complied with.

Q. 148. *The Directors of a company seek your advice whether the amount representing the Depreciation Fund should be left in the business or invested in gilt-edged securities. How would you advise?*

A. Before deciding upon whether it would be desirable to invest the Depreciation Fund inside or outside the business, the following factors would need to be determined:—

(1) Whether the nature of the business is such that its revenue-producing assets will need to be replaced at the end of some period.

(2) The period at the end of which such replacement would become necessary.

(3) Whether the Depreciation Fund, if allowed to get merged in the general assets of the business and furnish additional working capital, would be capable of being released from the business whenever required without seriously disturbing its financial resources.

(4) Whether such Fund if allowed to remain in the business can be so usefully and advantageously utilised as to make it more profitable to borrow moneys when required for replacement purposes.

(5) The present market value of the gilt-edged securities in which the Depreciation Fund is intended to be invested, and how far there are any likely chances of sustaining any loss on realization in the future due to adverse fluctuations.

Q. 149. *How would you distinguish a Capital Reserve from a Revenue Reserve? Mention the purposes for which each would be maintained.*

A. A Capital Reserve represents accumulations of Capital Profits such as (a) Premium on the Issue of Shares or Debentures, (b) Profits from sale of fixed assets, (c) Profit from re-issue of Forfeited Shares, (d) Profit due to over-insurance, or on claim for compensation, and (e) Profit prior to Incorporation or Commencement Certificate. Such profits are not normally available for distribution as dividends, and are usually conserved to enable the business to meet any capital loss such as loss on sale of a fixed asset, loss due to under-insurance, or loss on claim for compensation or heavy law-suit. Capital Reserve may also be utilised in wiping off intangible assets like Preliminary Expenses, Brokerage on Shares, Underwriting Commission, Organization or Development Expenses, or even sometimes Goodwill.

A Revenue Reserve is mainly created and maintained by holding back a portion of distributable profits from year to year, with a view to serve as additional working capital and thus strengthen the liquid position of the business, or to help towards expansion of the business by the acquisition of additional plant or other fixed assets, or to provide for meeting unknown losses or contingencies. Inasmuch as such a Reserve is made up of profits which would otherwise have been distributed, it is always available for the purpose of dividends, unless the company's Articles require a certain percentage of net profits to be specifically reserved.

Q. 150. *While asked to instal a system of Cost Accounting in a large manufacturing concern, state what particular points you would bear in mind so as to achieve maximum results.*

A. Any system of Costing to be of real value should answer the following requirements:—

- (1) It should be simple, pliable and effective.
- (2) It should not be unnecessarily laborious and costly.
- (3) It must help to determine the actual cost of each article, process, operation or service.
- (4) It must provide for the allocation of the Factory and Office Oncosts on most scientific and logical lines, so that each article, process or department gets its legitimate share of burden in this respect.
- (5) It must provide for the comparison of the actual costs with the estimates, and serve as a reliable guide to future estimates.
- (6) It must be capable of being easily reconciled with the financial accounts.
- (7) It must provide reliable statistical data in form of Reports and Statistics.
- (8) It must provide for ready reference to any detailed information required.
- (9) It must be capable of efficiently controlling and detecting any excessive costs, wastage, leakage, and any other unremunerative expense.

SPECIMEN PUBLISHED ACCOUNTS

**THE BANK OF
BALANCE SHEET**

<i>Liabilities</i>	Rs.	a.	p.	Rs.	a.	p.
Authorised Capital, two lacs Shares at Rs. 100 each ...	2,00,00,000	0	0			
Issued and Subscribed Capital, two lacs Shares at Rs. 100 each ...	2,00,00,000	0	0			
Paid-up Capital, two lacs Shares at Rs. 50 each ...				1,00,00,000	0	0
Reserve Fund				1,15,50,000	0	0
Reserve for Contingencies				3,50,000	0	0
Fixed, Short and Savings Bank Deposits				8,26,82,855	8	1
Current Deposits and Contingency (unadjusted) Accounts				14,38,79,468	8	2
Rebate on Bills Discounted and on Government of India Treasury Bills not due				42,410	9	1
Unclaimed Dividends				95,386	8	0
Profit and Loss Account :—						
Balance as per Balance Sheet on 31st December 1940 (after appropriation)	8,98,784	7	11			
Profit for the half-year ended 30th June 1941 ...	11,63,524	6	1			
	20,62,308	14	0			
Less Provision for Income-Tax and Super-Tax	1,50,000	0	0			
				19,12,308	14	0
Contingent Liabilities:--						
Claims against the Company not acknowledged as debts approximately Rs. 510.						

as on 30th June 1941.

Assets		Rs.	a.	p.	Rs.	a.	p.
Cash Credits and Demand Advances	...	...	...	...	7,78,25,369	0	5
Loans	...	...	...	...	4,10,62,854	14	6
Bills Discounted and Purchased	...	...	...	...	70,34,236	5	0
					12,59,22,460	3	11
Particulars Required by Act VII of 1913:—							
1. Debts considered good and in respect of which the Bank is fully secured	...	...	...	...	9,41,61,665	2	10
This amount includes debts (fully secured) due by firms in which a Director of the Bank is a partner or guarantor or debts due by Directors jointly with others	...	5,47,269	2	11			
The total of maximum Balances under this heading during the half-year was	...	7,68,701	3	9			
2. Debts considered good secured by the personal liability of one or more parties in addition to the personal security of the debtors	...				3,10,75,879	4	10
This amount includes:—							
Bills Discounted	...	66,90,150	0	0			
Debts due by Joint Stock Companies, guaranteed by their Agents, a Director of the Bank being a member of the firm of Agents	...	31,49,617					
The Total of maximum Balances under this heading during the half-year was	...	36,43,585					
Debts due by Directors jointly with others	...	9,731	0	0			
The total of maximum Balances under this heading during the half-year was	...	17,123	15	10			
3. Debts considered good for which the Bank holds no security other than the debtors' personal security	...				6,84,915	12	3
4. Debts considered doubtful	...				Nil		
5. Debts considered bad	...				Nil		
6. Debts due by Directors personally	...				Nil		
7. Debts due by an Officer of the Bank other than a Director	...				Nil		
					12,59,22,460	3	11
Stamps	...					1,728	5
Branch Adjustments	...					7,54,545	3
Landed Property, at or below cost, as per last Balance Sheet	...				15,02,119	4	3
Deduct—Written off 31-12-1940	...				2,50,000	0	0
					12,52,119	4	3
Add—Additions at cost during this half-year	...				81,425	11	6
Investments at or below Market Rate:—						13,33,544	15
Government Securities	...				4,69,57,779	0	4
Improvement Trust, Port Trust and Municipal Bonds...	...				72,09,060	5	6
Joint Stock Company Debentures, Preference and Ordinary Shares	...				15,92,437	13	10
Interest accrued up to 30th June 1941 on Government, Port Trust, Improvement Trust & Municipal Securities	...					5,57,59,277	3
Government of India Treasury Bills at par	...					4,28,124	4
Provincial Government	...				2,42,75,000	0	0
					5,00,000	0	0
					2,47,75,000	0	0
Cash in hand	...				1,34,42,827	4	2
„ at Bankers in Current Account	...				2,80,94,922	6	2
						4,15,37,749	10
						25,05,12,429	15

THE IMPERIAL BANK OF INDIA.
PROFIT AND LOSS ACCOUNT.
For the year ended 30th June 1941.

INCOME			Rs.	a.	p.	Rs.	a.	p.
Amount brought forward	...	...	39,62,566	9	8			
Gross Profit for the year	...	...	2,21,05,392	14	9	2,60,67,959	8	6
EXPENDITURE								
Establishment	...	...	1,04,18,514	1	0			
Directors' and Local Board Members' Fees	...	...	1,23,003	12	9			
Auditors' Fees	...	...	46,916	12	5			
Rent, Taxes, Insurance, Lighting, etc.	...	...	12,45,919	2	1			
Pay of Guards	...	...	1,97,612	1	8			
Depreciation on Bank Property	...	...	6,56,233	9	6			
Repairs to Bank Property	...	...	1,58,906	13	6			
Law Charges	...	...	30,147	10	7			
Postages and Telegrams	...	...	5,93,890	7	3			
Stationery	...	...	5,00,319	3	6			
Miscellaneous Expenses	...	...	5,89,073	5	8			
Total net available balance	...	...				1,45,60,536	15	11
						1,15,07,422	8	6
ALLOCATION FOR HALF-YEAR ENDED 31st DECEMBER 1940								
Amount set aside for payment of a Dividend at the rate of 12 per cent per annum (free of Income-tax)	...	...	33,75,000	0	0			
Amount transferred to Pension Funds	...	...	60,800	0	0	34,35,800	0	0
ALLOCATION FOR HALF-YEAR ENDED 30th June 1941								
Amount set aside for payment of a Dividend at the rate of 12 per cent per annum (free of Income-tax)	...	...	33,75,000	0	0			
Amount transferred to Pension Funds	...	...	1,34,700	0	0			
Balance carried forward	...	...	45,61,922	8	6	80,71,622	8	6

REPORT OF THE AUDITORS TO THE SHAREHOLDERS

We the undersigned Auditors of the Imperial Bank of India, elected under Section 58(1) of Schedule II of the Imperial Bank of India Act, 1920, do hereby report to the Shareholders upon the Balance Sheet and Accounts of the Bank as at 30th June 1941.

We have examined the above Balance Sheet with the Accounts and Vouchers relating thereto of the Central Office and of the Local Head Offices and with the Returns submitted and certified by the Branch Agents, which Returns are incorporated in the above Balance Sheet, and report that where we have called for explanations and information from the Central Board such information and explanations have been given and have been satisfactory. In our opinion, the Balance Sheet is a full and fair Balance Sheet containing the particulars prescribed by the Imperial Bank of India Act, 1920, and the Bye-laws of the Bank, and is properly drawn up so as to exhibit a true and correct view of the state of the Bank's affairs according to the best of our information and the explanations given to us, and as shown by the Books of the Bank.

The audit of the Local Head Offices at Calcutta, Bombay and Madras, has been carried out by Mr. James Orr, Sir Shapurji Billimoria and Mr. C. Gill respectively.

Calcutta, 25th July 1941.

Auditors.

**THE IMPERIAL
BALANCE SHEET**

<i>Liabilities</i>	Rs.	a.	p.	Rs.	a.	p.
Capital :—						
Authorised—2,25,000 Shares of Rs. 500 each	11,25,00,000	0	0			
Issued and Subscribed—2,25,000 Shares of Rs. 500 each	11,25,00,000	0	0			
Called up—75,000 Shares of Rs. 500 each, fully paid ..	3,75,00,000	0	0			
1,50,000 Shares of Rs. 500 each, Rs. 125 paid	1,87,50,000	0	0	5,62,50,000	0	0
Reserve Liability of Shareholders --Rs. 375 per share on 1,50,000 Shares	5,62,50,000	0	0			
Reserve Fund '				5,62,50,000	0	0
Fixed Deposit, Savings Bank, Current and other Accounts				105,14,32,664	13	1
Loans against Securities per contra						
Acceptances for Constituents						
Dividends :—						
For the half year ended 30th June 1941	33,75,000	0	0			
Unclaimed	4,17,566	12	2	37,92,566	12	2
Profit and Loss Account				45,61,922	8	6

Contingent Liabilities :—	Rs.	a.	p.
On Bills of Exchange rediscounted	27,75,848	0	0
Claims against the Bank not acknowledged as debts	11,640	1	2

117,22,87,154 1 9

BANK OF INDIA.

as on 30th June 1941.

<i>Assets</i>	Rs.	a. p.	Rs.	a. p.
Investments (of which securities are valued in accordance with Bye-law 29 of the Bye-laws of the Bank) :—				
• Government Securities	59,70,22,392	8		
Other Trustee Securities	55,29,093	13		
Other Authorised Securities	60,17,312	4		
Immovable Properties at or below cost ...	4,934	14		
			60,85,73,733	8 11
Advances :—				
Loans	7,15,49,387	0 11		
Cash Credits and Overdrafts	26,61,75,138	6 5		
Bills Discounted and Purchased	5,61,46,441	11 11		
			—|| 39,38,61,967	3 3
Particulars of Advances :—				
1. Debts considered good in respect of which the Bank is fully secured	37,59,83,378	7 2		
(This amount includes debts (fully secured) due by Directors, members of Local Boards and employees, or by them jointly with others, and by firms in which a Director or a member of a Local Board is a partner, aggregating Rs. 38,18 06 15-4, including Rs. 25,000 0 0 advanced to Directors and members of Local Boards since 30th June 1940 and recoverable.)				
2. Debts considered good for which the Bank holds no security other than the debtor's personal security	1,78,78,588	12 1		
(This amount includes debts due by Directors, members of Local Boards and employees, or by them jointly with others, and by firms in which a Director or a member of a Local Board is a partner, aggregating Rs. 1,10,804-10-2, including Rs. 47,072 11-1 advanced to Directors and members of Local Boards since 30th June 1940 and recoverable.)	39,38,61,967	3 3		
Liability of Constituents for Acceptances per contra ...				
Dead Stock :—	Promises	|| Furniture & Fittings		
Total cost up to the 30th June 1940	3,41,96,170 13	61,59,363 7 6		
Additions since 30th June 1940 ...	99,712 15	1,46,951 15 10		
	3,42,95,883 13	63,06,315 7 4		
Less sales since 30th June 1940 and adjustments in respect of property fully written off which has passed out of the Bank's possession ...	13,03,032	71,315		
	3,29,92,851	62,35,000		
Total depreciation written off up to the 30th June 1941 less depreciation previously provided on property which has passed out of the Bank's possession	1,66,40,205	47,15,467		
	1,63,52,645	15,19,533	1,78,72,178	10 8
Sundries (Stationery, Stamps, etc.)			15,73,077	6 11
Adjusting Account of interest, commission, etc.			33,89,575	2 2
Bullion				
Cash :—				
In hand and with the Reserve Bank of India	13,20,21,198	10 3		
Balances with other Banks :				
(a) On current account and at call 1,49,95,423 7 7				
(b) On deposit	1,49,95,423	7 7		
			14,70,16,622	1 10
			Rs. 117,22,87,154	1 9

ORIENTAL GOVERNMENT SECURITY
REVENUE ACCOUNT OF THE
For the year ended

	Business within India			Business out of India			Total		
	Rs.	a.	p.	Rs.	a.	p.	Rs.	a.	p.
Claims under policies (including provision for claims due or intimated), less Re-assurances :—									
By Death	60,87,583	5	6	6,81,813	1	8	67,69,396	7	2
By Maturity	71,40,350	14	3	13,84,793	15	5	85,25,144	13	8
							1,52,94,541	4	10
Annuities, less Re-assurances	65,278	7	0	2,061	2	8	67,339	9	8
Surrenders (including Surrenders of Bonus), less Re-assurances	17,04,607	2	5	2,20,180	11	0	19,24,787	13	5
Bonuses in Cash, less Re-assurances	1,04,832	6	0	31,040	10	0	1,35,873	0	0
Bonuses in Reduction of Premiums, less Re-assurances	1,542	9	0	447	8	0	1,990	1	0
EXPENSES OF MANAGEMENT :—									
(a) Commission to Insurance Agents, (less that on Re-assurances)	22,27,754	12	0	3,54,143	9	4	25,81,898	5	
(b) Allowances and Commission [other than commission included in sub-item (a) preceding]	1,75,305	1	0	4,002	6	0	1,79,307	7	0
Salaries including Bonus and Allowances (other than to agents and those contained in item No. 1)	25,02,562	0	4	3,65,080			28,67,642	10	0
Travelling Expenses	2,73,104	12	6	42,872			3,15,977	2	10
Directors' Fees	33,899	0	0	4,176			38,075	0	
Auditors' Fees	13,355	0	0	1,645			15,000	0	0
Medical Fees	3,92,001	13	0	51,689			4,43,690	13	8
Law Charges	20,191	13	9	2,101			22,292	15	
Advertisements	60,197	14	3	14,542			74,740	3	
Printing and Stationery	1,72,304	10	0	7,827			1,80,132	1	
Official Trustees' Fees	9,794	0	0	1,206			11,000	0	0
Carriage and Freight	27,947	13	3	1,152	10		29,100	7	
Postages and Telegrams	2,97,933	11	6	27,862	4		3,25,796	0	
Receipt Stamps	31,644	14	0	4,459	1		36,103	15	
Policy Stamps	30,625	8	0	3,451	2		34,076	10	0
Agency Remittance Charges	13,372	4	3	217	4		13,589	8	3
Bank Charges	42,818	2	6	2,743	13		45,562	0	1
Charges General	96,623	6	2	11,215	8		1,07,838	14	
Company's Contributions to Staff Pension Fund...	1,60,511	4	3	21,607	13		1,82,119	1	10
Triennial Investigation Expenses	4,761	0	0	587	0		5,348	0	0
Rents for Offices belonging to and occupied by the Company	96,824	0		23,776	8		1,20,600	8	0
Rents of other Offices occupied by the Company	56,884	3		2,211	2		59,095	5	
Doubtful Debt written off	440	10		.....			440	10	6
British Indian, States, and other Taxes	2,98,441	2		44,746	11		3,43,187	14	
Exchange	75,107	1		5,397	11		80,504	12	5
Gratuities to late Employees and their families ..	67,100	4		266	5		67,366	9	0
Special Retiring Allowances ... ..	.....			24,099	12		24,099	12	0
Depreciation on Furniture, Machinery, etc.	1,01,178	1		6,347	2		1,07,525	3	9
Transfer to Building Fund	13,192	0		4,441	6		17,633	6	8
Investments written down	80,345	13		9,897	0		90,242	13	3
Dividends payable on 23rd May 1940 for the year ended 31st December 1939	3,75,000	0	0				3,75,000	0	0
BALANCE OF FUND at the end of the year, as shown in the Balance Sheet :—									
Life Assurance Fund—	Rs.	a.	p.						
Trust Fund	20,45,40,838	4	3						
Balance of Life Assurance Fund	7,01,28,341	14	4						
	24,44,46,175	3	10	3,02,23,004	14	2	27,46,69,180	2	7
Rs.	26,73,01,592	0	11	3,35,87,108	1	2	30,08,88,700	2	1

As per our Report of even date.

..... } Auditor

LIFE ASSURANCE COMPANY, LIMITED.
LIFE ASSURANCE BUSINESS.
31st December 1940.

	Business within India		Business out of India		Total	
	Rs.	a. p.	Rs.	a. p.	Rs.	a. p.
BALANCE OF FUND at the beginning of the year:—						
Life Assurance Fund—						
Trust Fund	19,35,29,843	3 1				
Balance of Life Assurance Fund	5,86,39,378	5 8				
	22,45,12,742	6 9	2,76,56,479	2 0	25,21,69,221	8 9
PREMIUMS, less Re-assurances:—						
Total						
First Year's Premiums ...	36,51,142	9 0	31,50,176	4 0	5,00,966	5 0
Renewal Premiums	3,34,66,004	14	2,93,19,074	13 5	41,46,930	1 1
Single Premiums	1,65,953	0 0	1,39,659	4 0	26,293	12 0
Interest, Dividends and Rents:—						
On Trust Fund Investments	85,99,088	15 9				
On other Investments ...	33,58,563	14 2				
	1,19,57,652	13 11				
Less—Income-tax thereon	7,58,335	10 9	99,68,938	9 9	12,30,378	9 5
					1,11,99,317	3
Registration Fees ...			23	0 0	23	0
Transfer and other Fees			2,697	10 0	2,955	6
Refund of Income-tax paid to Indian States and British Colonies			1,082	1 0	1,125	7 8
Unclaimed Dividends and Bonus Dividends forfeited			6,875	0 0	6,875	0
Net amount transferred from the Contingencies Reserve Fund			2,00,323	0 0	24,677	0 0
Gross Premiums written in India,						
Rs. 3,28,27,890-11-5						

Rs. 26,73,01,592 0 11 3,35,87,108 1 2 30,08,88,700 2 1

Chairman.

Directors.

**ORIENTAL GOVERNMENT SECURITY
BALANCE
As on the 31st**

<i>Liabilities</i>					Rs.	a	p.
SHAREHOLDERS' CAPITAL:—							
Authorised—5,000 Shares of Rs. 200 each	...	...	...	...	Rs. 10,00,000	0	0
Issued, Subscribed and Called-up—3,000 Shares of Rs. 200 each Fully Paid-up	...	...	...	...	6,00,000	0	0
Contingencies Reserve Fund	...	...	...	...	3,82,431	15	11
Building Fund	...	...	...	...	2,56,460	0	10
					12,38,892	0	9
LIFE ASSURANCE FUND:—					Rs.	a	p.
Trust Fund	...	...	...	...	20,45,40,838	4	3
Balance of Life Assurance Fund	...	...	...	...	7,01,28,341	14	4
					27,46,69,180	2	7
				Total Funds	27,59,08,072	3	4
Estimated Liability in respect of outstanding Claims, whether due or intimated					43,82,104	0	10
Unclaimed Surrender Values	...	...	...	...	55,702	3	3
Annuities due and unpaid	...	...	...	...	1,852	10	4
Outstanding Dividends	...	...	...	...	13,500	0	0
Sundry Creditors, including Commission on Outstanding Premiums	...	...	...	...	18,23,223	5	4
Premiums, etc., Deposits	...	...	...	...	11,55,488	4	11
Security and other Deposits	...	...	...	...	1,86,261	9	2
Cheques issued but not presented for payment	...	...	...	...	10,26,336	15	3
CONTINGENT LIABILITIES:—							
(1) Uncalled liability as at 31-12-1940 on shares (since sold)					Rs. 6,600		
(2) Claim against the Company not acknowledged as a debt:—							
					Rs. 18,39,000 or in the alternative Rs. 6,98,050 or		
					Rs. 6,25,000		

Rs. 28,45,52,541 4 5

As per our Report of, even date.

Chief Accountant.

Auditors.

LIFE ASSURANCE COMPANY, LIMITED.
SHEET.
December 1940.

	Assets		Ra	a	p.
Loans on the Company's Policies within their Surrender Values inclusive of Loans of \$571,823	3,00,94,603	15	4
INVESTMENTS:—					
Deposit with the Reserve Bank of India, Calcutta:—					
3½% Government of India Promissory Notes 1900-01	1,72,000	0	0
Deposit with the Reserve Bank of India, Rangoon, as Security for Policyholders in Burma:—					
3½% Government of India Promissory Notes 1947-50	2,00,000	0	0
Deposit with the Accountant-General, Travancore, as Security for Policyholders in Travancore State:—					
5% Government of India Promissory Notes 1945-55	50,000	0	0
Deposit with the Comptroller, Mysore Government, as Security for Policyholders in Mysore State:—					
3% Mysore Government Loan, Free of Income Tax, 1956-61	1,01,333	12	0
Deposit with the Accountant-General, Baroda, as Security for Policyholders in Baroda State:—					
3½% Government of India Promissory Notes 1842-43	1,17,578	2	0
Deposit with the Accountant-General, Straits Settlements, as Security for Policyholders in the Straits Settlements:—					
4% Rangoon Port Trust Debentures	3,11,111	1	9
Indian Government Securities (including Deposit with the Official Trustee of Bombay, Rs. 20,70,00,820-15-7)	21,20,51,425	8	7
Provincial Government Securities	24,68,955	8	0
British, British Colonial and British Dominion Government Securities	9,90,000	0	0
Indian Municipal Securities	70,89,998	6	8
British and Colonial Securities	8,66,104	2	8
Bonds, Debentures, Stocks and other Securities, whereon Interest is guaranteed by the Indian Government or a Provincial Government	11,97,158	0	10
Port Trust, Calcutta Improvement Trust Debentures and New Howrah Bridge Loan	63,15,067	0	3
Preference or Guaranteed Shares of Railways in India	985	0	0
Other Debentures and Debenture Stock of Companies incorporated in India	1,00,090	0	0
Other Guaranteed and Preference Stocks and Shares of Companies incorporated in India	8,50,493	12	0
		Ra	a	p.	
House Property in India on Freehold land	...	26,22,788	9	5	
House Property in India on Leasehold land	...	26,95,498	8	5	
		53,18,287	1	10	
House Property out of India on Freehold land	...	14,53,475	3	11	
		67,71,762	5	9	
Agents' Balances	...	2,47,981	4	3	
Outstanding Premiums	...	57,28,285	4	6	
Interest, Dividends and Rents outstanding (net)	...	11,41,981	0	0	
Interest, Dividends and Rents accruing but not due (net)	...	28,69,520	4	1	
Amounts due from other Persons or Bodies carrying on Insurance Business	...	1,07,250	0	0	
Sundry Debtors	...	95,431	4	6	
CASH:—					
At Bankers on Current Account and in hand	...	32,49,996	3	9	
Balance in Official Trustee's hand	...	0	1	0	
Cheques paid into Bank and in course of realisation	...	7,85,167	0	0	
Furniture, Sares, Fittings, Machinery, Electric Installation, etc.	...	4,24,145	1	1	
Advances on account of Premiums, etc.	...	1,69,943	13	9	
Security and other Deposits in Government of India Paper, etc.	...	1,86,263	3	8	
		Ra	28,45,52,541	4	5

Chairman.
 Directors.
 Manager.

*ORIENTAL GOVERNMENT SECURITY LIFE ASSURANCE COMPANY, LIMITED.***We certify that—**

Investments in Stocks and Shares as at 31st December 1940 have been valued at or below cost and at or below Market Value. Except certain Preference Shares, all other Investments in Stocks and Shares stand at or below par. The Market Values of these Investments have been ascertained as per market quotations prevailing at the time of the closing of the markets for the Xmas and the New Year holidays and as given by our Bankers, excluding therefrom the accrued interest where it is included in the quotations.

The values of all the Assets have been reviewed as at 31st December 1940 and that in our belief the Assets set forth in the Balance Sheet are shown in the aggregate at amounts not exceeding their realisable or market value under the several headings:—
“Loans”, “Investments”, “Agents’ Balances”, “Outstanding Premiums”, “Interest, Dividends and Rents outstanding”, “Interest, Dividends and Rents accruing but not due”, “Amounts due from other Persons or Bodies carrying on Insurance Business”, “Sundry Debtors”, “Cash”, “Cheques paid into Bank and in course of realisation”, “Furniture, Safes, Fittings, Machinery, Electric Installation, etc.”, “Advances on account of Premiums, etc.”, and “Security and other Deposits in Government of India Paper, etc.”

No part of the Assets of the Life Assurance Fund has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938, relating to the application and investment of Life Insurance Funds.

The Sterling Values of the Assets have been converted at 1s. 6d. to the Rupee and the Straits Dollar Values at \$100 to Rs. 156½.

Chairman.

Directors.

Manager.

ORIENTAL GOVERNMENT SECURITY LIFE ASSURANCE COMPANY, LIMITED.

AUDITORS' REPORT

To

*The Shareholders and the Policyholders of the
Oriental Government Security Life Assurance Company, Limited,*

Bombay.

Gentlemen,

We have audited the annexed Balance Sheet of The Oriental Government Security Life Assurance Company, Limited, as at 31st December 1940, and the Revenue Account of the Company for the year ended upon that date with the books and accounts at the Head Office in which are incorporated the returns from the various branches and agencies and beg to report that:—

- (a) we have obtained all the information and explanations which we have required;
- (b) in the Revenue Account indirect expenses and the net amount transferred from the Contingencies Reserve Fund have been allocated in regard to business within India and business out of India in proportion of opening Life Fund, and interest has been apportioned on the basis of Mean Life Fund as determined by the Company's Actuary;
- (c) in our opinion the annexed Balance Sheet and Revenue Account are drawn up in conformity with the law;
- (d) Such Balance Sheet exhibits a true and correct view of the state of the Company's affairs according to the best of our information and the explanations given to us and as shown by the books of the Company;
- (e) in our opinion books of accounts have been kept by the Company for the year under report as required by Section 130 of the Indian Companies Act;
- (f) we have verified the Cash Balances and Investments by actual inspection or by production of certificates or vouchers and have also verified the Securities relating to the Company's Loans on the Company's Policies; and
- (g) no part of the assets of the Life Assurance Fund has been applied directly or indirectly in contravention of the Insurance Act, 1938, relating to the application and investment of Life Insurance Fund.

Further, we certify in terms of the Deed of Trust, dated 29th March 1882, that 80 per cent of the Gross Premiums received during the year, and the Interest on Trust Fund, Investments, after deducting Claims, Pensions, Surrenders, Loans on Policies, Re-assurance Premiums, Bonuses in Cash and in reduction of premiums to Policyholders and Dividends, amount to Rs. 1,10,10,995-1-2 and the same have been added to the Trust Fund as under:—

	Rs. •	a. p.
Amount of Trust Fund at 31st December 1939	19,35,29,843	1 2
Addition to Trust Fund in 1940	1,10,10,995	3 1
Trust Fund at 31st December 1940, as per the Balance Sheet ..	20,45,40,838	4 3
Book Value of Government Securities of the Face Value of Rs. 14,88,70,800 and £6,915,165 at 1/6=Rs. 9,22,02,200 aggregating to Rs. 24,10,73,000 held by the Official Trustee of Bombay	20,70,09,820	15 7
Cash in his hand at 31st December 1940 (Re. 0-0-1 and £0-0-1 = Re. 0-0-11)		0 • 1 0
	20,70,09,821	0 7
Deduct—Book Value of Securities lodged with the Official Trustee of Bombay in excess of the Book Value of Securities required to be lodged with him pursuant to the Trust Deed ..	24,68,982	12 4
	Rs. 20,45,40,838	4 3

Yours faithfully,

Auditors.

Bombay, 7th May 1941.

FORM AA

Classified Summary of the Assets in India of the Oriental Government Security Life Assurance Company Limited, on 31st December 1940.

Class of Assets	Book Value as prescribed		Market Value as prescribed		REMARKS
	Ra	a p.	Ra	a p.	
1. Government of India Securities (excluding Deposit with Reserve Bank of India, Rangoon, 3½% Loan of the face value of Rs. Two lakhs) ..	21,23,91,003	10 7	23,97,00,033	9 0	
2. Indian Provincial Government Securities ..	24,66,955	8 0	25,23,673	6 0	
3. Indian Municipal, Port and Improvement Trust Securities including Debentures	1,33,65,665	6 11	1,55,12,348	6 10	
4. Debentures of Indian Railways ..	.....		.....
5. Guaranteed and Preference Shares of Indian Railways	985	0 0	1,030	0 0	
6. Annuities of Indian Railways ..	.....		.....
7. Ordinary Shares of Railways in India ..	.....		.....
8. Other Debentures of Concerns in India ..	13,36,558	0 10	14,84,715	10 0	
9. Other Guaranteed and Preference Shares of Concerns in India ..	8,50,493	12 0	9,09,606	0 0	
10. Other Ordinary Shares of Concerns in India ... ..	.....		.....
11. Loans on the Company's Policies effected in India and within their Surrender Value	2,60,19,306	12 8	2,60,19,306	12 8	Realisable Value.
12. Loans on Mortgage of Property in India ..					
13. Loans on Personal Security to persons resident in India					
14. Other Loans granted in India (particulars to be stated)					
15. Land and House Property in India ...	53,18,287	1 10	53,18,287	1 10	Cost price. Building Fund provided for.
16. Cash on Deposit in Banks in India ...					
17. Cash in hand and on Current Account in Banks in India	24,34,616	5 5	24,34,616	5 5	Realisable Value.
18. Agents' Balances and Outstanding Premiums	53,20,723	2 8	53,20,723	2 8	Realisable Value.
19. Interest, Dividends and Rents either outstanding or accrued but not due ..	33,92,762	5 10	33,92,762	5 10	Realisable Value.
20. Other Assets in India:—					
3% Mysore Government Loan (Tax Free) 1936-61	1,01,333	12 0	1,03,657	8 0	
Amounts due from other Persons or Bodies carrying on Insurance Business	1,07,250	0 0	1,07,250	0 0	Realisable Value.
Furniture, Sates, Machinery, etc. ...	3,98,973	14 3	3,98,973	14 3	Realisable Value.
Sundry Debtors	89,349	1 3	89,349	1 3	Realisable Value.
Advances on account of premiums, etc.	1,58,125	8 9	1,58,125	8 9	Realisable Value.
Unashed Cheques	7,38,054	9 2	7,38,054	9 2	Realisable Value.
Cash in the hands of the Official Trustee		0 1 0		0 1 0	Realisable Value.

The Sterling Values of the Assets have been converted at 1s. 6d. to the Rupee.

..... Chairman.

Directors.

Manager.

As on 31st December 1940.

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The Book Value of the above Assets is in the aggregate considerably within their Market or Realisable Value.

(The above Statement appears at the end of the Accounts, but has been printed here for sake of convenience.)

THE EMPIRE OF INDIA LIFE
REVENUE ACCOUNT OF THE
For the year ended

	Business within India			Business out of India			Total		
	Rs.	a.	p.	Rs.	a.	p.	Rs.	a.	p.
Claims under Policies (including provision for claims due or intimated), less Re-insurances :—									
By Death ...	12,62,935	0	0	91,076	0	0	13,54,011	0	0
By Maturity ...	30,44,445	0	0	1,45,443	0	0	31,89,888	0	0
Annuities, less Re-insurances ...	2,856	0	0	.....			2,856	0	0
Surrenders (including Surrenders of Bonus), less Re-insurances ...	4,67,467	8	9	20,788	0	0	4,88,255	8	9
Commission to Insurance Agents (less that on Re insurances) ...	3,71,257	1	0	15,307	3	6	3,86,564	4	6
EXPENSES OF MANAGEMENT :—									
Allowances and Commission (other than Commission to Insurance Agents) ...	1,83,563	8	6	2,692	14	0	1,86,256	6	6
Salaries, etc. (other than to Agents and those contained in the above item) ...	4,13,571	5	0	28,580	0	0	4,42,151	5	0
Travelling Expenses ...	21,156	14	9	3,405	0	0	24,561	14	9
Directors' Fees ...	19,207	0	0	968	0	0	20,175	0	0
Auditors' Fees ...	2,856	0	0	144	0	0	3,000	0	0
Law Charges " ...	8,667	4	6	553	0	0	9,220	4	6
Advertisements ...	17,764	9	6	1,123	0	0	18,887	9	6
Printing and Stationery ...	41,572	6	5	1,903	0	0	43,475	6	5
Medical Fees ...	71,680	13	0	3,591	0	0	75,271	13	0
Policy Stamps ...	5,278	2	0	231	12	0	5,509	14	0
Actuarial Fees ...	13,237	2	9	1,130	0	0	14,367	2	9
General Charges ...	24,083	1	5	1,890	0	0	25,973	1	5
Banks' Charges and Commission ...	15,533	6	10	755	0	0	16,288	6	10
Employees' Annual and Provident Bonus ...	52,408	8	0	3,562	0	0	55,970	8	0
Postage and Receipt Stamps ...	62,658	9	6	2,267	0	0	64,925	9	6
Rents for Offices belonging to and occupied by the Company ...	18,924	0	0	954	0	0	19,878	0	0
Rents of Other Offices occupied by the Company, ...	13,773	8	0	3,982	0	0	17,755	8	0
Provision for British Indian Income and Super Tax—1940-41 Assessment ...	1,55,218	0	0	7,857	0	0	1,63,075	0	0
Indian States :—									
Income and Super Tax ...	9,440	10	1	.....			9,440	10	1
Aden :—									
Income and Super Tax ...	Rs. 682	a. 8	p. 0						
Less Refunds ...	252	11	0						
Retiring Allowances ...	26,275	0	0	429 13 0			27,600	0	0
Donations :—				1,325 0 0					
Red Cross Fund " ... 500 0 0									
War Gifts Fund (I.A.F.) 4,000 0 0									
	4,284	0	0	216 0 0			4,500	0	0
Depreciation on Furniture, Machinery and Safes ...	8,073	4	0	258 0 0			8,331	4	0
Balance of Life Insurance Fund at the end of the year as shown in the Balance Sheet ...	4,78,18,088	8	8	24,12,250 8 5			5,02,30,339	1	1
Ra.	5,41,56,276	4	8	27,52,682 2 11			5,69,08,958	7	7

ASSURANCE COMPANY, LIMITED.

LIFE INSURANCE BUSINESS.

31st December 1940.

	Business within India		Business out of India		Total	
	Rs.	a. p.	Rs.	a. p.	Rs.	a. p.
Balance of Life Insurance Fund at the beginning of the year ...	4,58,75,260	6 10	23,30,679	4 11	4,82,05,939	11 9
Premiums, <i>less</i> Re-insurances :—						
First Year Premiums ...	6,11,935	12 0	29,241	13 0	6,41,177	9 0
Renewal Premiums ...	53,99,611	7 0	2,74,612	10 0	56,74,224	1 0
Single Premiums ...	48,122	2 0	1,120	13 0	49,242	15 0
Consideration for Annuities granted, <i>less</i> Re-insurances ...	5,575	0 0			5,575	0 0
Interest, Dividends and Rents						
Rs. a.	25,00,799	14				
<i>Less</i> Income-Tax thereon	1,73,496	13 8				
	22,15,167	0 10	1,12,136	0 0	23,27,303	0 10
Refund of Income and Super Tax :—						
Burma ...			4,883	2 0	4,883	2 0
Registration Fees ...	189	8 0	1	0 0	190	8 0
Endorsement Fees ...	415	0 0	7	8 0	422	8 0

Gross Premiums written
in India, Rs. 60,74,768-9-0

Rs. 5,41,56,276 4 8 . 27,52,682 2 11 5,69,08,958 7 7

THE EMPIRE OF INDIA LIFE
BALANCE SHEET OF THE
On the 31st

<i>Liabilities</i>	<i>Rs.</i>	<i>a.</i>	<i>p.</i>	<i>Rs.</i>	<i>a.</i>	<i>p.</i>
Life Insurance Fund	5,02,30,339	1	1			
Life Insurance Reserve Fund	1,71,658	0	0			
Investment Reserve Fund	28,06,918	0	0			
Surrender Value Reserve Fund	2,96,241	0	0			
				5,35,05,156	1	1
Estimated Liability in respect of outstanding claims, whether due or intimated				12,57,174	0	0
Deposits on account of premia				73,333	13	1
Sundry Creditors (including outstanding and accruing expenses and taxes) ..				4,26,816	9	6
Employees' Deposits, per contra				38,875	0	0

Rs. 5,53,01,355 7 8

ASSURANCE COMPANY, LIMITED.

LIFE INSURANCE BUSINESS.

December 1940.

<i>Assets</i>	<i>Rs.</i>	<i>a.</i>	<i>p.</i>	<i>Rs.</i>	<i>a.</i>	<i>p.</i>
Loans on Company's Policies, within their Surrender Values	...	..		72,87,871	0	0
Investments :—						
Deposits with the Reserve Bank of India :—						
Calcutta—Rs. 2,00,000 4% Government Loan 1960-70	1,61,000	0	0			
Rangoon—(as security for Policyholders in Burma)						
Rs. 2,00,000 4% Government Loan 1960-70	1,61,000	0	0	3,22,000	0	0
Deposit with the Government of Mysore :—						
Bangalore—(as security for Policyholders in Mysore)						
Rs. 2,00,000 3% Government of Mysore Loan 1956-61				1,82,000	0	0
Government of India Securities :—						
Rs. 22,26,000, 2½% Government Loan 1948-52	20,04,593					
„ 4,00,000, 3% Do. Defence Bonds 1946	3,80,000					
„ 6,25,000, 3% Do. Loan 1951-54	6,04,724					
„ 1,50,75,000, 4% Do. do. 1960-70	1,24,40,802			1,54,30,119	0	0
Indian State Government Securities :—						
Rs. 3,00,000 3% Government of Mysore Loan 1956-61				2,74,067	0	0
British and British Colonial Government Securities :—						
£ 26,000 3% British Government War Loan 1955-59	3,28,118					
Rs. 1,00,000 4% Ceylon Government Inscribed Stock	88,000			4,16,118	0	0
Indian Municipal and Port Trust Securities :—						
Rs. 41,75,500 4% Bombay Municipal Debentures	35,48,720	0	0			
£ 14,900 4% Do. do. Sterling Loans	1,49,397	0	0			
£ 1,200 6% Calcutta Corporation Sterling Loan	15,163	0	0			
Rs. 22,41,000 4% Bombay Port Trust Loans	17,52,203	0	0			
£ 5,000 6% Do. do. Sterling Loan	63,986	0	0			
Rs. 9,35,500 4% Calcutta Port Trust Loan	6,24,261	0	0			
Rs. 22,60,000 5% Do. do. do.	18,08,001	0	0			
£ 22,600 5% Do. do. Sterling Loan	2,41,006	0	0			
£ 22,900 5½% Do. do. do. do.	2,93,261	0	0			
£ 21,900 5½% Karachi Port Trust Sterling Loan	2,79,343	0	0	87,75,341	0	0
Securities whereon Interest is guaranteed by the Government of India :—						
£ 410,000 3% India Sterling Loan 1949-52	52,03,279	0	0			
£ 1,455,000 3½% Do. do. 1954-59	1,52,35,464	0	0	2,04,38,743	0	0
House Property in India	9,19,000	0				
Less House Property Reserve Fund	6,19,000	0		3,00,000	0	0
Branch and Agency Balances				1,95,828	4	1
Outstanding Premiums				3,74,940	0	0
Interest, Dividends and Rents Outstanding (Net)				97,727	0	0
Do. do. do. accruing but not due (Net)				4,13,678	0	0
Cash at Bankers on Current Account and in hand				6,80,548	3	7
Office Furniture, Machinery and Safes				73,500	0	0
Imperial Bank of India—Employees' Deposits, per contra				38,875	0	0
				Rs. 5,53,01,355	7	8

THE EMPIRE OF INDIA LIFE ASSURANCE COMPANY, LIMITED.
BALANCE SHEET on the 31st December 1940.

<i>Liabilities</i>		<i>Assets</i>	
	Ra.		Ra.
<i>Shareholders' Capital:—</i>		<i>Investments:—</i>	
Authorised, Subscribed and Called-up Capital,		Government of India Securities—	
5,150 Shares of Rs. 100 each—fully Paid	5,15,000	Ra. 4,24,000 23% Government	4,24,000
Shareholders' Fund	2,59,526	Loan 1948-52	3,96,417
Outstanding Dividends	9,514	Ra. 5,50,000 4% Government	5,50,000
Sundry Creditors (Provision for Income and Super Tax)	4,619	Loan 1960-70	3,67,271
Funds of the Life Insurance Business as per separate Balance Sheet	5,35,05,156	Interest, Dividends and Rents accruing but not due (Net)	...
Outstanding Liabilities of the Life Insurance Business as per separate Balance Sheet	17,96,199	Cash at Bankers on Current Account and in hand	...
	6 7	Assets of the Life Insurance Business as per separate Balance Sheet	...
			7,63,688
			0 0
			5,636
			0 0
			19,335
			0 0
			5,53,01,355
			7 8
			5,60,90,014
			7 8

We certify that—

All the Investments are in Stock Exchange Securities and moreover being in Terminable Loans are repayable on fixed dates at par but in the case of 3% Government Defence Bonds, 1946 repayment will be at 101 per cent. Irrespective of the Investment Reserve Fund the aggregate Book Value of the Investments is not only substantially below the Market Value on 31st December 1940 as ascertained from quotations supplied by the Imperial Bank of India, Bombay, but is considerably below their value at redemption.

The Values of all the Assets have been reviewed as at 31st December 1940 and in our belief the Assets set forth in the Balance Sheet are shown in the aggregate at amounts not exceeding their realisable or market value under the several headings—Loans, Investments, House Property in India, Branch and Agency Balances, Outstanding Premiums, etc.

No part of the Assets of the Life Insurance Fund has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938, relating to the application and investment of Life Insurance Funds.

The Values of Sterling Securities have been converted at 1s. 6d. to the Rupee.

Manager.

Chairman.

Directors.

Bombay, 3rd March 1941.

THE EMPIRE OF INDIA LIFE ASSURANCE COMPANY, LIMITED.
REVENUE ACCOUNT OF THE SHAREHOLDERS' FUND.

	Ra.	a.	p.
Dividend and Bonus paid "Free of Tax" to Shareholders on 7th May 1940 for the year ended 31st December 1939.	...	...	...
Provision for British Indian Income and Super Tax, 1940-41 Assessment	...	...	...
Donation to War Gifts Fund (L.A.F.)	...	...	...
Balance of Shareholders' Fund at the end of the year as shown in the Balance Sheet	...	...	...
	Ra.	a.	p.
	87,550	0	0
	3,028	0	0
	1,000	0	0
	2 59,526	0	0
	3,51,104	0	0
Balance of Shareholders' Fund at the beginning of the year	...	...	...
Interest	...	...	...
Less—Income Tax thereon	...	...	...
Transfer Fees	...	...	...
	Ra.	a.	p.
	34,191	0	0
	5,496	3	0
	132	0	0
	3,22,277	3	0
	28,694	13	0
	3,51,104	0	0

REPORT OF THE AUDITORS TO THE SHAREHOLDERS.

We have audited the above Balance Sheet as at 31st December 1940 and the foregoing Revenue Accounts for the year ended on that date and we Report that we have obtained all the information and explanations we have required. We certify that we have verified the cash balances and the Securities relating to the Company's Loans and investments by inspection of the various documents and Bankers' Certificates, and that no part of the Assets of the Life Insurance Fund has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938 relating to the application and investment of Life Insurance Funds. We further report that in our opinion the said Balance Sheet and Revenue Accounts are drawn up in conformity with the Law and that such Balance Sheets exhibit a true and correct view of the state of the Company's affairs according to the best of our information and the explanations given to us and as shown by the books of the Company. In our opinion, books of account have been kept by the Company as required by Section 130 of the Indian Companies Act.

Bombay, 3rd March 1941.

..... Auditors.

THE NEW INDIA ASSURANCE COMPANY, LIMITED.

FIRE REVENUE ACCOUNT.

For the year ended 31st December 1940.

	Ra	a	p	Ra	a	p		Ra	a	p	Ra	a	p	
Claims under policies less re-insurances: Paid during the year ...	11,89,724	8	11				Balance of Account at the beginning of the year :— Reserve for Unexpired Risks	13,59,214	0	0				
Total estimated liability in respect of outstanding claims at the end of the year whether due or intimated ...	6,33,333	5	4				Additional Reserve ...	25,30,000	0	0	38,89,214	0	0	
Total ...	18,23,057	14	3				Premiums less re-insurances ...				36,35,826	3	0	
Less— Outstanding at the end of the previous year ...	5,34,866	10					Interest and Dividends ...	1,23,062	3	0				
				12,88,191	3	7	Less—Income-tax thereon ...	13,388	5	0	1,09,673	14	0	
Commission ...				7,88,581	14	8								
Expenses of Management ...				4,29,696	7	11								
United Kingdom, Foreign and Dominion Taxes ...				38,515	12	2								
Bad Debts ...				2,841	0	9								
Profit transferred to Profit and Loss Account ...				9,02,556	9	11								
Balance of Account at the end of the year as shown in the Balance Sheet:— Reserve for Unexpired Risks being 40% of the Premium Income of the year	14,54,331	0	0				Owing to the exigencies of War, Accounts from certain Ceding Companies for a complete year have not been received ..							
Additional Reserve ...	27,30,000	0	0	41,84,331	0	0								
				Ra	76,34,714	1	0				Ra	76,34,714	1	0
Claims paid to claimants in India ..	1,20,306	0	3				Premiums derived from business effected in India ...				12,13,075	4	7	
Claims paid to claimants outside India ...	10,69,418	8	8				Premiums derived from business effected outside India...				24,22,750	14	0	

As per our Report annexed.

Auditors.

Bombay, dated the 5th June 1941.

THE NEW INDIA ASSURANCE COMPANY, LIMITED.

MISCELLANEOUS INSURANCE REVENUE ACCOUNT.

For the year ended 31st December 1940.

	Rs.	a.	p.	Rs.	a.	p.		Rs.	a.	p.	Rs.	a.	p.
claims under policies less re-insurances:							Balance of Account at the beginning of the year:—						
Paid during the year	4,23,997	1					Reserve for Un-expired Risks	4,77,373	0	0			
Total estimated liability in respect of outstanding claims at the end of the year whether due or intimated	3,32,217	15	6				Additional Reserve	7,40,000	0	0	12,17,373	0	0
Total	7,56,215	1	2				Premiums less re-insurances				11,63,140	8	8
— Outstanding at the end of the previous year	2,49,811	8	11				Interest and Dividends	37,889	15	0			
				5,06,403	8		Less—Income-tax thereon	4,107	12	0	33,782	3	0
Commission				2,13,997	1	11							
Expenses of Management				1,26,664	5								
United Kingdom, Foreign and Dominion Taxes				1,408	11	6							
Debts				2,351	14	0							
Profit transferred to Profit and Loss Account				2,98,214	2	10							
Balance of Account at the end of the year as shown in the Balance Sheet:—													
Reserve for Un-expired Risks being 40% of the Premium Income of the year	4,65,256	0	0										
Additional Reserve	8,00,000	0	0	12,65,256	0	0							
				Rs.	24,14,295	11 3					Rs.	24,14,295	11 3
Claims paid to claimants in India	3,11,250	8	1				Premiums derived from business effected in India				77,26,130	8	2
Claims paid to claimants outside India	1,12,746	1	7				Premiums derived from business effected outside India				4,37,010	0	1

Chairman.

Directors.

General Manager.

THE NEW INDIA ASSURANCE
MARINE REVENUE
For the year ended

	1940		1939		1938 and previous years		Total	
	Rs.	a. p.	Rs.	a. p.	Rs.	a. p.	Rs.	a. p.
Claims paid (<i>less</i> Salvages and Re-insurances) ...	7,39,800	13 0	7,45,415	8 3	6,25,605	11 4	21,10,822	0 7
Commission	3,15,210	11 3					3,15,210	11 3
Expenses of Management	1,42,663	9 11					1,42,663	9 11
United Kingdom, Domi- nion and Foreign Taxes	11,269	13 11					11,269	13 11
Bad Debts	342	1 0	144	4 1	624	13 3	1,111	2 4
Return Premiums, Re- insurances, etc.			1,75,457	2 5	30,724	0 9	2,06,181	3 2
Balance of Marine Insu- rance Business Account at the end of the year as shown in the Balance Sheet:—								
Balances ...	29,13,478	6 7	13,20,321	10 4	2,55,337	8 3	44,89,137	9 2
Ra.	41,22,765	7 8	22,41,338	9 1	9,12,292	1 7	72,76,396	2 4
Claims paid to claimants in India	1,15,277	7 4	44,140	0 10	4,538	13 1		
Claims paid to claimants outside India	6,24,523	5 8	7,01,275	7 5	6,21,066	14 3		
Return Premiums, Re- insurances, etc. pertain- ing to business effected in India			57,069	15 8	311	7 0		
Return Premiums, Re- insurances, etc. pertain- ing to business effected outside India			1,18,387	2 9	30,412	9 9		

In compliance with Form E of the Third Schedule of the Insurance Act, 1938, out-
standing Marine claims amounting to Rs. 10,82,244-3-0 have not been debited.

As per our Report annexed.

Auditors.

Bombay, dated the 5th June 1941.

COMPANY, LIMITED.
ACCOUNT.
31st December 1940.

	1940	1939	1938 and previous years	Total
	Rs. a. p.	Rs. a. p.	Rs. a. p.	Rs. a. p.
Balance of Marine Insurance Business Account at the beginning of the year:—				
Balances ..		22,04,143 5 9	9,09,164 3 1	31,13,307 8 10
Premiums (less Returns, Re-insurances, Brokerages and Discount) ...	40,16,943 13 8			40,16,943 13 8
Interest and Dividends	Rs. a. p. 1,18,738 5 0			
Less Income-tax thereon	12,916 11 0			
	1,05,821 10 0			1,05,821 10 0
Commission recovered ...		37,195 3 4	3,127 14 6	40,322 1 10
	Rs. 41,22,765 7 8	Rs. 22,41,338 9 1	Rs. 9,12,292 1 7	Rs. 72,76,396 2 4

Premiums derived from business effected in India 6,17,602 3 4

Premiums derived from business effected outside India ... 33,99,341 10 4

Chairman.

Directors.

General Manager.

THE NEW INDIA ASSURANCE
REVENUE ACCOUNT OF THE LIFE
For the year ended

	Business within India		Business out of India		Total	
	Rs.	a. p.	Rs.	a. p.	Rs.	a. p.
Claims under Policies (including provision for Claims due or intimated) <i>less</i> Re-insurance :—						
By Death	4,19,280	1 0	33,766 15 0		4,53,047	0 0
„ Maturity	1,06,229	7 0	1,700 0 0		1,07,929	7 0
„ Disability	7,200	0 0	.....		7,200	0 0
Annuities <i>less</i> Re-insurances	8,204	4 0	.....		8,204	4 0
Surrenders including Surrenders of Bonus Additions <i>less</i> Re-insurances	1,09,390	12 0	6,201 14 0		1,15,592	10 0
EXPENSES OF MANAGEMENT :—						
Commission to Insurance Agents (<i>less</i> that on Re-insurances)	3,26,126	10 0	.....		3,26,126	10 0
Allowances and Commission (other than Commission to Insurance Agents)	1,06,474	10 0	61,637 5 7		1,68,111	15 7
Salaries, etc. (other than to Agents contained above)	3,07,230	1 2	32,756 14 7		3,39,986	15 9
Travelling and Conveyance Expenses	58,383	7 10	10,232 11 7		68,616	3 5
Directors' Fees	8,145	4 2	674 11 10		8,820	0 0
Auditors' Fees	3,981	5 9	393 10 3		4,375	0 0
Medical Fees	36,439	13 0	14,883 8 9		51,323	5 9
Law Charges	6,311	0 6	267 0 0		6,578	0 6
Advertisements	9,273	14 10	1,875 13 4		11,149	12 2
Printing and Stationery	58,990	0 1	1,075 7 0		60,065	7 1
Rent	19,605	0 3	3,652 11 9		23,257	12 0
Actuarial Charges	100	0 0	.....		100	0 0
Policy Stamps	5,270	14 0	537 9 8		5,808	7 8
Postages, Telegrams and Receipt Stamps	27,784	13 1	2,090 11 5		29,875	8 6
Bank and Remittance Charges	8,809	12 5	519 8 9		9,329	5 2
Telephone Charges	2,340	6 4	717 15 10		3,058	6 2
Expenses on Claims	2,610	2 4	.....		2,610	2 4
Exchange ... ..	.....		5,793 3 0		5,793	3 0
Lighting and Fans	2,500	13 11	380 12 5		2,881	10 4
Hollerith Running Expenses	13,368	13 3	1,107 7 0		14,476	4 3
Miscellaneous Charges	20,992	4 11	2,655 8 4		23,647	13 3
Bad Debts	345	5 0	.....		345	5 0
Contribution to Staff Provident Fund	23,560	8 0	1,435 8 0		24,996	0 0
Depreciation on Furniture, Motor Cars, Adrema Equipment and Hollerith Accessories	16,806	2 5	515 2 1		17,321	4 6
Balance of Life Assurance Fund at the end of the year as shown in the Balance Sheet	1,62,99,663	10 10	8,64,545 15 10		1,71,64,209	10 8
Ra	1,80,15,419	6 1	10,49,418	2 0	1,90,64,837	8 1

Indirect Expenses have been allocated in proportion of premium income.
Interest has been allocated in proportion of Mean Life Funds.

As per our Report annexed

Auditors

Bombay, dated the 5th June 1941.

COMPANY, LIMITED.
ASSURANCE BUSINESS.
31st December 1940.

	Business within India	Business out of India	Total
	Rs. a. p.	Rs. a. p.	Rs. a. p.
Balance of Fund at the beginning of the year	1,19,66,488 12 5	6,08,424 14 3	1,25,74,913 10 8
PREMIUMS LESS RE-INSURANCES :—			
(I) First Year Premiums	5,24,908 8 0	91,541 14 10	6,16,450 6 10
(II) Renewal Premiums	39,65,502 12 8	2,80,439 5 4	42,45,942 2 0
(III) Single Premiums	23,352 6 0	706 5 0	24,058 11 0
Consideration for Annuities granted less Re-insurance	1,02,590 14 0		1,02,590 14 0
Interest and Dividends	6,27,271 12 6		
Less—Income-tax thereon	43,947 12 9		
	Rs. 5,83,323 15 9		
Assignment, Endorsement and other Fees	5,54,432 8 0	28,891 7 9	5,83,323 15 9
	809 11 6	32 4 3	841 15 9
Transfer of Portfolio on revision of Re-insurance Treaty	6,79,778 3 3	29,034 0 0	7,08,812 3 3
Reserve for Depreciation of Investments written back ...	1,97,555 10 3	10,347 14 7	2,07,903 8 10
	Rs. 1,80,15,419 6 1	10,49,118 2 0	1,90,64,837 8 1

Chairman.

General Manager. •

Directors.

**THE NEW INDIA ASSURANCE
BALANCE
As at 31st**

	Life and Annuity Business		Other Classes of Business		Total	
<i>Liabilities</i>	Rs.	a. p.	Rs.	a. p.	Rs.	a. p.
SHAREHOLDERS' CAPITAL :—						
Authorized 800,000 Shares of Rs. 75 each ...	6,00,00,000					
Subscribed 474,737 Shares of Rs. 75 each ...	3,56,05,275					
Called-up 474,737 Shares of Rs. 15 each			71,21,055	0 0	71,21,055	0 0
RESERVE OR CONTINGENCY ACCOUNTS :—						
General Reserve ...			2,50,000	0 0	2,50,000	0 0
Investment Reserve ...			5,92,282	14 7	5,92,282	14 7
Exchange Reserve ...			57,950	15 6	57,950	15 6
Profit and Loss Appropriation Account Balance ...			9,84,394	9 0	9,84,394	9 0
BALANCES OF FUNDS AND ACCOUNTS :—						
Life Assurance Fund ...	1,71,64,209	10 8			1,71,64,209	10 8
Fire Insurance Business Account ...			41,84,331	0 0	41,84,331	0 0
Marine Insurance Business Account ...			44,89,137	9 2	44,89,137	9 2
Miscellaneous Insurance Business Account ...			12,65,256	0 0	12,65,256	0 0
Leasehold Redemption Assurance and Sinking Fund Business Account ...			9,594	6 1	9,594	6 1
Estimated liability in respect of outstand- ing claims, whether due or intimated ...	5,66,361	6 0	9,65,551	4 10	15,31,912	10 10
Outstanding Dividends ...			84,448	11 0	84,448	11 0
Amounts due to other persons or bodies carrying on Insurance Business ...	44,953	14 0	13,20,684	13 4	13,65,638	11 4
Sundry Creditors including outstanding commissions and expenses and taxes ...	3,77,192	14 3	6,25,428	9 11	10,02,621	8 2
Balance of Refund of Capital due to Share- holders ...			44,085	0 0	44,085	0 0
Premiums received in Advance ...			7,814	14 0	7,814	14 0
Staff Compassionate and Charitable Allow- ance Fund Account ...			19,650	0 0	19,650	0 0
Reserve for taxation ...	79,903	8 6	9,51,065	1 3	10,30,968	9 9
Reserve for Bad and Doubtful Debts ...	11,650	0 0	25,800	0 0	37,450	0 0
Life Department Current Account per contra ...			61,715	12 6	61,715	12 6
Premium and other Deposits ...	2,15,290	12 6			2,15,290	12 3
Carried over Rs.	1,84,59,562	1 8	2,30,60,216	9 2	4,15,19,808	10 10

COMPANY, LIMITED.
SHEET.
December 1940.

Assets	Life and Annuity Business			Other Classes of Business			Total		
	Rs.	a.	p.	Rs.	a.	p.	Rs.	a.	p.
Loans on Mortgages of Property within British India ...	6,69,322	0	0	2,90,000	0	0	9,59,322	0	0
Loans on Mortgages of Property outside British India ...	53,200	0	0	74,022	14	10	1,27,222	14	10
Loans on Insurer's Policies within their Surrender Value ...	7,36,965	10	8				7,36,965	10	8
Loan on Life Interest ...	12,000	0	0				12,000	0	0
Advances to Policyholders under Automatic Non-Forfeiture Benefit ...	6,52,224	9	0				6,52,224	9	0
INVESTMENTS at or below Cost :-									
5% War Loan 1945-55 (Deposit with the Reserve Bank of India, Calcutta)	2,24,774	3	4	2,44,549	3	6	4,69,323	6	10
5% War Loan 1945-55 (Deposit with the Reserve Bank of India, Rangoon as security for Policyholders in Burma)	2,24,774	3	4				2,24,774	3	4
5% War Loan 1945-55 (Deposit with the Accountant-General, Travancore State as security for Policyholders in Travancore)	56,193	8	10				56,193	8	10
4½% India Sterling Stock 1950-55 (Deposit with the Paymaster General in London as security for Policyholders in United Kingdom and British Colonies)	3,38,693	11	7				3,38,693	11	7
5% War Loan 1945-55 (Deposit with the Accountant-General, Baroda State as security for Policyholders in Baroda)	56,193	8	10				56,193	8	10
5% War Loan 1945-55 (Deposit with the Accountant-General, Kashmir State as security for Policyholders in Jammu and Kashmir)	14,048	6	3				14,048	6	3
5% Union of South Africa Stock 1950-70 (Deposit with the Minister of Finance, Union of South Africa as security for Policyholders in South Africa)	1,34,259	13	10				1,34,259	13	10
Indian Government Securities ...	34,65,137	5	9	93,08,641	2	11	1,27,73,778	8	8
Provincial Government Securities ...	1,98,000	0	0				1,98,000	0	0
British Dominion Government Securities ...				4,06,628	8	0	4,06,628	8	0
Indian Municipal, Port and Improvement Trust Securities ...	35,50,869	10	6	17,63,953	8	8	53,14,823	3	2
Burma Municipal Securities ...	37,300	0	0				37,300	0	0
Foreign Municipal Securities ...				16,695	0	0	16,695	0	0
Debentures of Railways in India	3,88,680	3	11				3,88,680	3	11
Preference or Guaranteed Shares of Railways in India	1,05,633	14	8	66,784	0	0	1,72,417	14	8
Ordinary Shares of Railways in India	46,852	8	0				46,852	8	0
Other Debentures and Debenture Stocks of Companies incorporated in India	6,10,413	8	0	5,63,000	0	0	11,73,413	8	0
Other Debentures and Debenture Stocks of Companies incorporated out of India	39,150	0	0	36,000	0	0	75,150	0	0
Other Guaranteed and Preference Stocks and Shares of Companies incorporated in India	17,61,039	0	4	7,34,521	0	2	24,95,560	0	6
Carried over Rs.	1,33,75,725	14	10	1,35,04,795	6	1	2,68,80,521	4	11

THE NEW INDIA ASSURANCE
BALANCE

		Life and Annuity Business		Other Classes of Business		Total	
		Rs.	a. p.	Rs.	a. p.	Rs.	a. p.
<i>Brought forward</i>	Rs.	1,84,59,562	1 8	2,30,60,246	9 2	4,15,19,808	10 10

Contingent Liabilities :—

	Rs.	1,84,59,562	1 8	2,30,60,246	9 2	4,15,19,808	10 10
On Investment in Shares of Joint Stock Companies...	Rs.	1,77,596	10 8	9,63,190	0 0	11,40,786	10 8

The Company has guaranteed Fire Policies of the South India Fire and General Insurance Co. (Coimbatore) Ltd., to the extent of Rs. 3,05,000.

COMPANY, LIMITED.
SHEET—(Continued).

	Life and Annuity Business			Other Classes of Business			Total		
Assets—Contd.	Ra.	a.	p.	Ra.	a.	p.	Ra.	a.	p.
<i>Brought forward</i>	1,33,75,725	14	10	1,35,94,795	6	1	2,68,80,521	4	11
Other Guaranteed Preference Stocks and Shares of Companies incorporated out of India ...	80,256	1	7	45,600	0	0	1,25,946	1	7
Other Ordinary Stocks and Shares of Companies incorporated in India ...	17,76,720	4	3	14,65,875	2	6	32,42,595	6	9
Other Ordinary Stocks and Shares of Companies incorporated out of India...	1,35,396	3	5	3,26,027	4	0	4,61,413	7	5
House Property in India (Freehold) ...				9,80,380	12	0	9,80,380	12	0
Agents' Balances (Including Rs. 11,650 in "Life and Annuity Business" considered doubtful and reserved as <i>per contra</i>) ...	85,031	1	1	2,28,760	10	7	3,14,691	11	8
Outstanding Premiums (Including Rs. 25,684-4-6 in "Other Classes of Business" considered doubtful and reserved as <i>per contra</i>) ...	4,38,325	9	3	15,12,493	14	5	19,50,819	7	8
Interest Outstanding ...	58,322	6	0	1,250	0	0	59,572	6	0
Interest accruing but not due ...	1,12,517	6	0	1,36,448	2	7	2,48,965	8	7
Amounts due from other persons or bodies carrying on Insurance Business ...				31,844	6	8	31,844	6	8
Sundry Debtors including Advances and Deposits (including Rs. 115-11-6 in "Other Classes of Business" considered doubtful and reserved as <i>per contra</i>) ...	5,353	14	5	11,877	1	9	17,231	0	2
Advances to company's Employees and Representatives for purchase of Motor Cars	7,844	11	0	...	...	...	7,844	11	0
Cash at Bankers on Deposit Account ...	13,50,000	0	0	26,05,916	10	8	39,55,916	10	8
Cash at Bankers on Current Account and in hand ...	6,71,844	5	4	14,16,249	11	6	20,88,094	0	10
Cash Deposit with Indian State for Insurance Business ...	1,00,000	0	0	1,25,000	0	0	2,25,000	0	0
Cash Deposit for purchase of Debentures (since allotted) ...	1,00,000	0	0	10,000	0	0	1,10,000	0	0
Remittances in transit ...	15,356	14	4	35,297	15	5	50,654	13	9
General Department Current Account <i>per contra</i>) ...	61,715	12	6				61,715	12	6
	Life and Annuity Business			Other Classes of Business					
Furniture, Motor Cars, Adma Equipment and Hollerith ...	Ra.	a.	p.	Ra.	a.	p.			
accessories at cost	1,55,641	15	10	1,75,621	10	1			
Less—Depreciation to date	71,380	6	2	1,75,621	10	1			
				84,261	9	8	84,261	9	8
Staff Compassionate and Charitable Allowance Fund Investment at cost:									
4% Government of India Loan 1960-70...				19,650	0	0	19,650	0	0
Reserve deposited with Ceding Companies less held on account of Re-insurances ceded by the Company:									
(British Government Securities of Face Value of £ 9,000 also held as deposit from a Treaty Company)				6,02,689	7	0	6,02,689	7	0
	Ra.			1,84,59,562	1	8	2,30,60,246	9	2
							4,15,19,808	10	10

Part of the Assets has been deposited under local Laws or by Contract in various places in and outside British India as security to holders of policies issued.

(Directors' and Auditors' Reports appear on page 587.)

THE NEW INDIA ASSURANCE COMPANY, LIMITED.
LEASEHOLD REDEMPTION ASSURANCE & SINKING FUND ACCOUNT.

For the year ended 31st December 1940.

	Rs.	a.	p.		Rs.	a.	p.
Expenses of Management	275	4	0	Leasehold Redemption Assurance and Sinking Fund at the beginning of the year	6,304	10	1
Leasehold Redemption Assurance and Sinking Fund at the end of the year as shown in the Balance Sheet	9,594	6	1	Premiums	3,212	10	0
				Interest	352	6	0
	Rs.				Rs.		
	9,869	10	1		9,869	10	1

THE NEW INDIA ASSURANCE COMPANY, LIMITED.

'PROFIT AND LOSS ACCOUNT.

For the year ended 31st December 1940.

	Rs.	a.	p.		Rs.	a.	p.		Rs.	a.	p.
Expenses of Management (not applicable to any particular Fund or Account)	1,13,052	14	8	Interest and Dividends (not applicable to any particular Fund or Account)	4,07,951	7	0				
Contribution to Staff Provident Fund	33,013	0	0	Less—Income-Tax thereon	45,657	8	7		3,62,293	14	5
Furniture and Motor Cars written off	18,215	12	2	Transfer Fees					5,248	2	0
Exchange Adjustments	10,895	9	4	Profit transferred from Fire Revenue Account					9,02,556	9	11
Balance for the year carried to Appropriation Account	13,96,786	14	2	Profit transferred from Miscellaneous Insurance Revenue Account					2,98,214	2	10
				Profit on Sale of Furniture and Motor Cars					3,651	5	2
	Rs.				Rs.				Rs.		
	15,71,967	2	4		13,71,964	2	4				

THE NEW INDIA ASSURANCE COMPANY, LIMITED.

PROFIT AND LOSS APPROPRIATION ACCOUNT.

For the year ended 31st December 1940.

	Rs.	a.	p.		Rs.	a.	p.		Rs.	a.	p.
Transferred to Reserve for Bad and Doubtful Debts	87,118	13	10	Balance Brought Forward from last year	9,86,832	0	8				
Transferred to General Reserve	1,25,000	0	0	Less—Dividends since declared free of Tax	7,12,105	8	0		2,74,726	8	8
Transferred to Reserve for Taxation	4,75,000	0	0	Balance for the year brought from Profit and Loss Account					13,96,786	14	2
Balance at the end of the year as shown in the Balance Sheet	9,84,394	9	0		Rs.				Rs.		
	Rs.				16,71,513	6	10		16,71,513	6	10

General Manager.

As per our Report annexed.

Auditors.

Chairman.

Directors.

Bombay, dated the 5th June 1941.

THE NEW INDIA ASSURANCE COMPANY, LIMITED.

We certify that—

1. Investments have been valued in the Balance Sheet at or below cost. The book values of Investments are in the aggregate below the market prices at 31st December 1940. The market prices of all Investments have been ascertained as per market quotations on 31st December 1940 given by Brokers or Bankers, excluding therefrom the accrued interest where it is included in the quotations.

2. The values of all the Assets have been reviewed as at 31st December 1940 and that in our belief, subject to the Reserve for Bad and Doubtful Debts on the "Liabilities" side of the Balance Sheet, the Assets set forth in the Balance Sheet are shown in the aggregate at amounts not exceeding their realizable or market value under the several headings.

3. Ample provision has been made for the Liabilities of the Company except that, in accordance with Form E of the Third Schedule of the Insurance Act, 1938, outstanding Marine Claims amounting to Rs. 10,82,244-3-0 have not been debited in the Marine Revenue Account and consequently no provision has been made on the Liabilities side of the Balance Sheet for that amount.

4. No part of the Assets of the Life Assurance Fund has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938, relating to the application and investment of Life Assurance Funds.

Chairman.

Directors.

General Manager.

Bombay, dated the 5th June 1941.

REPORT OF THE AUDITORS TO THE SHAREHOLDERS

We have audited the annexed Balance Sheet of the New India Assurance Company, Limited, as at 31st December 1940, the Fire, Miscellaneous Insurance, Marine and Life Revenue Accounts, the Leasehold Redemption Assurance and Sinking Fund Account and the Profit and Loss Account and the Profit and Loss Appropriation Account of the Company for the year ended upon that date in which are incorporated the Returns from various Branches and Agencies, and we beg to report that:—

- (a) We have obtained all the information and explanations which we have required.
- (b) In our opinion, the annexed Balance Sheet, Revenue Accounts, Profit & Loss Account and Profit & Loss Appropriation Account are drawn up in conformity with the law.
- (c) In compliance with Form E of the Third Schedule of the Insurance Act, 1938, outstanding Marine claims amounting to Rs. 10,82,244-3-0 have not been debited in the Marine Revenue Account and consequently no provision has been made on the Liabilities side of the Balance Sheet for the amount.
- (d) Subject to remarks in (c) above such Balance Sheet exhibits a true and correct view of the state of the Company's affairs according to the best of our information and the explanations given to us and as shown by the books of the Company.
- (e) In our opinion, books of accounts have been kept by the Company for the year under report as required by Section 130 of the Indian Companies Act.
- (f) We have verified the cash balances and investments by actual inspection or by the production of certificates or vouchers and verified the securities relating to the loans.
- (g) No part of the Assets of the Life Assurance Fund has been directly or indirectly applied in contravention of the Insurance Act, 1938, relating to the application and investment of Life Assurance Funds.
- (h) The outstanding Premia due by the Directors or their Firms on current insurance business have not been stated separately: such accounts have since been adjusted.

Auditors.

Bombay, dated the 5th June 1941.

FORM AA

THE NEW-INDIA ASSURANCE COMPANY, LIMITED.
CLASSIFIED SUMMARY OF THE ASSETS IN INDIA.
As on 31st December 1940.

Class of Assets	Book Value as prescribed		Market Value as prescribed		Remarks
	Rs.	a. p.	Rs.	a. p.	
Government of India Securities (excluding Deposit with Reserve Bank of India, Rangoon, with Paymaster General, London, Foreign Governments, and with Banks outside India)	1,18,74,442	15 10	1,25,84,045	0 0	
Indian Provincial Government Securities	1,98,000	0 0	1,97,409	6 0	
Indian Municipal, Port & Improvement Trust Securities including Debentures	53,14,823	3 2	54,77,778	1 4	
Debentures of Indian Railways	3,88,680	3 11	3,08,413	5 4	
Guaranteed and Preference Shares of Indian Railways	1,72,417	14 8	1,64,225	3 2	
Ordinary Shares of Railways in India	46,852	8 0	37,818	5 4	
Other Debentures and Preference Shares of concerns in India	11,73,413	8 0	12,06,854	0 0	
Other Guaranteed and Preference Shares of concerns in India	24,93,560	0 6	27,27,297	8 0	
Other Ordinary Shares of concerns in India	32,42,595	6 9	35,02,382	12 0	
Loans on Company's Policies effected in India and within their Surrender Value	7,03,509	0 0	7,03,509	0 0	Realisable Value
Loans on Mortgage of Property in India	9,59,322	0 0	9,56,322	0 0	"
Loans on Life Interest	12,000	0 0	12,000	0 0	"
Advances to Policyholders under Automatic Non-Forfeiture Benefit	6,24,790	9 0	6,24,790	9 0	"
Loan under Apprenticeship Scheme	2,652	15 0	2,652	15 0	"
Land & House Property in India	9,80,380	12 0	9,80,380	12 0	Cost
Cash on Deposits in Banks in India	34,00,000	0 0	34,00,000	0 0	Realisable Value
Cash on Deposits with Indian States for Insurance Business	2,25,000	0 0	2,25,000	0 0	"
Cash on Deposit for purchase of Debentures (since allotted)	1,10,000	0 0	1,10,000	0 0	"
Cash in Hand and on Current Account with Banks in India	14,23,181	1 8	14,23,181	1 8	"
Cash in Transit	49,100	15 5	49,100	15 5	"
Agents' Balances and Outstanding Premiums	14,33,256	4 6	14,21,606	4 6	"
Interest and Dividends either outstanding or accrued but not due	2,88,123	15 9	2,88,123	15 9	"
Sundry Debtors	11,570	7 5	11,454	11 11	"
Furniture, Motor Cars and Adreana Equipment	78,967	1 5	78,967	1 5	"
Advances to Company's Employees & Representatives for purchase of Motor Cars	7,844	11 0	7,844	11 0	"
Amounts due from other persons or bodies carrying on Insurance Business	15,938	7 6	15,938	7 6	"
Rs.	3,52,32,424	1 6	3,65,80,096	2 4	

The Sterling Values of the Assets have been converted at 1s. 6d. to the Rupee.

FORM DD
THE NEW INDIA ASSURANCE COMPANY, LIMITED.
CLASSIFIED STATEMENT OF LIFE INSURANCE POLICIES.
For the year ending 31st December 1940.

New Life Insurance business in respect of which a Premium has been paid in the year.				Total Life Insurance business in force at end of the year.			Premium Income for which Credit has been taken in the Revenue Account.
No. of Policies.	Sums insured and Annuities per Annum.	Single Premiums (including consideration for immediate (or deferred) Annuities and all other Premiums paid at the outset where no subsequent Premium is payable).		Yearly Renewal Premium Income.	No. of Policies.	Sums insured with Bonuses and Annuities per Annum.	
		Rs.	Re.				
In India ...	4,439	1,13,55,100	23,373	5,83,490	33,492	8,09,30,327	45,13,764
Out of India ...	842	22,55,121	706	1,25,173	2,072	66,70,060	3,72,683
Total ...	5,281	1,36,10,221	24,059	7,08,663	35,564	8,76,00,386	48,86,452
*Annuity Contracts etc.—							
In India ...	8	8,499	1,00,068	1,043	15	13,565	1,02,591
Out of India ...	...	...	...	...	...	...	...
Total ...	8	8,499	1,00,068	1,043	15	13,565	1,02,591
Group Insurance Policies—							
In India ...	...	...	...	...	...	...	...
Out of India ...	...	...	...	...	...	...	...
Total ...	...	...	...	...	...	...	...

The amounts stated are to the nearest rupees and after deduction of re-insurances.

**THE SHREE NIWAS
BALANCE
As at 31st**

<i>Capital & Liabilities</i>	Ra.	a p.	Ra.	a p.
CAPITAL :—				
Authorised :—				
30,000 Shares of Rs. 100 each			30,00,000	0 0
Issued & Subscribed :—				
24,000 Shares of Rs. 100 each fully paid up			24,00,000	0 0
Taxation Reserve			1,50,000	0 0
Depreciation Provision out of Current Year's Profits .			2,50,000	0 0
Loans :—				
Secured :—				
Cash Credit Account with the Bank of India, Ltd., against hypothecation of Stock of Cotton and Cloth Bales			9,57,760	15 6
"Overdraft Account with Mercantile Bank of India, Ltd., secured on investments as per contra			2,376	1 11
Unsecured :—				
	Ra.	a p.		
Advances from firms in which some of the Directors are interested... ..	9,00,000	0 0		
Balances on Current Accounts with the Managing Agents and other firms in which some of the Directors are interested	7,21,590	11 3		
Interest due on the above advances	2,040	3 6	16,23,630	14 9
			25,83,768	0 2
Deposits :—				
From Cloth Dealers and Others .			1,06,105	12 6
Liabilities :—				
For Goods Supplied			45,846	9 3
For Expenses			2,75,076	3 11
For Managing Agents' Remuneration			60,000	0 0
For Unpaid Wages and Salaries .			18,773	3 9
For Other Finances			41,164	11 0
			4,46,360	11 11
Carried over Ra.			59,30,534	8 7

COTTON MILLS, LIMITED.
SHEET.
 December 1940.

<i>Property & Assets</i>	<i>Rs.</i>	<i>a.</i>	<i>p.</i>	<i>Rs.</i>	<i>a.</i>	<i>p.</i>
FIXED CAPITAL EXPENDITURE:—						
Land:—(at cost) ...				1,79,578	11	6
Buildings for Mills:—(at cost)						
Balance as per last Balance Sheet	2,95,708	10	7			
Additions during the year ...	17,823	9	5			
	3,13,532	4	0			
Less : Depreciation written off:—	<i>Rs.</i>	<i>a.</i>	<i>p.</i>			
In previous years	24,969	0	0			
For the year 1939	13,537	0	0	38,506	0	0
				2,75,026	4	0
Dyeing and Bleaching Buildings:—(at cost)						
Balance as per last Balance Sheet	2,27,819	7	11			
Less : Depreciation written off:—	<i>Rs.</i>	<i>a.</i>	<i>p.</i>			
In previous years ...	26,936	0	0			
For the year 1939 ...	20,091	0	0	47,027	0	0
				1,80,792	7	11
Plant and Machinery:—(at cost less sale proceeds)						
Balance as per last Balance Sheet ...	13,99,923	2	1			
Additions during the year ...	8,906	11	10			
	14,08,829	13	11			
Less : Depreciation written off:—	<i>Rs.</i>	<i>a.</i>	<i>p.</i>			
In previous years	1,88,349	0	0			
For the year 1939	1,78,310	0	0	3,66,659	0	0
				10,42,170	13	11
Dyeing and Bleaching Plant:—(at cost)						
Balance as per last balance Sheet	4,56,087	10	1			
Additions during the year ...	16,852	15	11			
	4,72,940	10	0			
Less : Depreciation written off:—	<i>Rs.</i>	<i>a.</i>	<i>p.</i>			
In previous years	73,778	8	0			
For the year 1939	57,347	0	0	1,31,125	8	0
				3,41,815	2	0
Electric Installation:—(at cost)						
Balance as per last Balance Sheet	1,80,376	8	5			
Additions during the year ...	6,947	0	5			
	1,87,323	8	10			
Less : Cost of Electric Motors sold	5,000	0	0			
	1,82,323	8	10			
Less : Depreciation written off:—	<i>Rs.</i>	<i>a.</i>	<i>p.</i>			
In previous years	31,761	0	0			
For the year 1939	22,293	0	0			
	54,054	0	0			
Less : Depreciation written off:—						
On Electric Motors sold	542	0	0	53,512	0	0
				1,28,811	8	10
<i>Carried over Rs.</i>				21,48,195	0	2

THE SHREE NIWAS
BALANCE

<i>Capital & Liabilities—Contd.</i>				Rs.	a.	p.	Rs.	a.	p.
<i>Brought over</i>							59,30,534	8	7
Profit and Loss Account:—									
Balance as per last Balance Sheet	...	...	...	2,21,971	15	10			
<i>Less : Appropriations as under :—</i>									
Provision for Depreciation	...	1,25,000	0 0						
Provision for Taxation	...	75,000	0 0						
				2,00,000	0	0			
				21,971	15	10			
<i>Add : Transfer of unpaid wages up to the year 1938</i>	...	...	...	7,720	4	6			
Profit on Sale of Electric Motors	...			Ra.	a.	p.			
				3,042	0	0			
<i>Less : Loss on Sale of Motor Lorry</i>	...								
				30	0	0			
				3,012	0	0			
Net Profit for the year as per Profit and Loss Account	...	...	...	80,171	9	10			
							1,12,875	14	2

Total Rs.

60,43,410 6 9

(Auditors' Report appears on page 594.)

Bombay, 26th June 1941.

COTTON MILLS, LIMITED.
SHEET—(Continued).

<i>Property & Assets—Contd.</i>		Rs.	a.	p.	Rs.	a.	p.
<i>Brought over</i>					21,48,195	0	2
Furniture :—(at cost)							
Balance as per Balance Sheet	...	9,302	1	6			
Additions during the year	...	1,333	3	6			
	Rs. a. p.	10,635	5	0			
Less : Depreciation written off :—							
In previous years	1,024	0	0				
For the year 1939	549	0	0				
		1,573	0	0	9,062	5	0
Motor Cars and Lorries :—(at cost)							
Balance as per last Balance Sheet		17,400	0	0			
Add : Cost of Truck purchased		3,979	0	0			
		21,379	0	0			
Less : Cost of Lorry sold		4,750	0	0			
		16,629	0	0			
Less : Depreciation written off :—							
In previous years	5,587	0	0				
For the year 1939	2,149	0	0				
	7,736	0	0				
Less : Depreciation written off on Lorry sold	3,969	0	0				
		3,767	0	0	12,862	0	0
Stores, Spare Parts, Coal, Fuel Oil, Dyeing & Bleaching Materials, Grains, Etc.—(at cost) As per Inventories certified by the Managing Agents					8,42,924	14	10
Stock-in-Trade :							
As per Inventories certified by the Managing Agents :—							
Cotton, Yarn, Waste and Work-in-Progress at cost and Cloth unsold at Market Rates, and Cloth sold at contract rates					25,53,193	15	10
Book Debts :—(Unsecured but considered good)							
Due by Cloth Dealers and others		2,74,494	9	2			
Sundry Outstanding		16,844	2	1	2,91,338	11	3
Advances & Deposits :							
Advances to Officers and Staff of the Company		5,163	7	9			
Deposits for Rents, etc.		3,040	0	0	8,203	7	9
Investments :—(at cost)							
50 4½% Debentures of Rs. 1,000/- each in Union Jute Co., Ltd.		50,000	0	0			
50 4½% Debentures of Rs. 1,000/- each in Lansdowne Jute Co., Ltd.		50,000	0	0			
3 5½% Debentures of Rs. 5,000/- each in Bishwanath Tea Co., Ltd.		15,450	0	0			
2 5% Debentures of Rs. 5,000/- each in India General Navigation and Railway Co., Ltd.		10,700	0	0	1,26,150	0	0
					2,912	8	0
Interest Accrued on Investment							
Cash & Other Balances :—							
Cash on hand		43,395	6	10			
With Bankers on Current Accounts		172	1	1	48,567	7	11
Total Rs.					60,43,410	6	9

} *Directors.*

THE SHREE NIWAS
PROFIT AND
For the year ended

	Rs.	a.	p.	Rs.	a.	p.
To Stock on hand on 1st January 1940 :—						
Cotton, Cloth, Yarn and Waste	25,77,833	2	1			
Chemicals, Stores, Fuel Oil and Coal	4,40,977	4	1			
				30,18,810	6	2
„ Purchases :—						
Cotton and Yarn	38,52,056	6	0			
Chemicals, Stores, Fuel Oil, Coal and Grains	15,50,096	4	3			
				54,02,152	10	3
„ Gas and Electric Motive Power				2,70,746	6	11
„ Wages				19,47,974	11	6
„ Water Consumption				45,778	14	0
„ Brokerage, Commission, Mucadamage and other						
Selling Expenses				57,871	5	8
„ Establishment Charges :—						
Salaries	2,19,988	15	9			
Rent, Rates, Taxes and Insurance	57,965	6	1			
General Establishment Expenses, including Printing and Stationery, Postage, Telegrams and Telephone, Advertisements, Travelling and Motor Car Expenses, Law Charges and other Miscellaneous Expenses	55,130	14	10			
Medical Relief and Maternity Welfare	5,257	15	6			
Directors' Fee	225	0	0			
Auditors' Fee	600	0	0			
				3,39,168	4	2
„ Donation to Bombay War Gifts Fund				2,500	0	0
„ Building Repairs				13,849	7	4
„ Interest on Loans, Deposits, Overdrafts, etc.				1,14,301	12	9
„ Managing Agents' Minimum Remuneration				60,000	0	0
„ Profit, carried down				5,74,447	9	10
Total Rs.				1,18,47,601	8	7
To Depreciation due for the year 1939	2,94,276	0	0			
Less Appropriation out of last year's Profits	1,25,000	0	0			
				1,69,276	0	0
„ Provision for Depreciation for 1940				2,50,000	0	0
„ Provision for Taxation				75,000	0	0
„ Balance, being Net Profit carried to Balance Sheet				80,171	9	10
	Rs.			5,74,447	9	10

REPORT OF THE AUDITORS TO THE SHAREHOLDERS.

We have audited the Balance Sheet of The Shree Niwas Cotton Mills, Ltd., as at 31st December 1940, above set forth, and the sub-joined Profit and Loss Account for the year ended upon that date, in which are incorporated the certified Returns from Calcutta Selling Agents, and we report that :—

- (a) We have obtained all the information and explanations we have required ;
- (b) in our opinion the above Balance Sheet and the sub-joined Profit and Loss Account are drawn up in conformity with the Law ;
- (c) such Balance Sheet exhibits a true and correct view of the state of the Company's affairs according to the best of our information and the explanations given to us and as shown by the books of the Company at Bombay ; and
- (d) in our opinion, books of account have been kept by the Company as required by Section 130 of the Indian Companies Act.

..... Auditors.

Bombay, 26th June 1941.

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